



August 5, 2016

*Via Electronic Mail*

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

Office of the Comptroller of the Currency  
400 7<sup>th</sup> 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

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

Re: Notice of Proposed Rulemaking – Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements

Ladies and Gentlemen:

The Clearing House Association L.L.C., 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 (collectively, the “Associations”)<sup>1</sup> appreciate the opportunity to comment on the joint notice of proposed rulemaking of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (together, the “Agencies”) to establish a net stable

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<sup>1</sup> See Annex A to this letter for descriptions of the Associations.

funding ratio requirement in the United States.<sup>2</sup> The proposal would apply: (i) to bank holding companies, savings and loan holding companies without significant commercial or insurance operations, and depository institutions that, in each case, have \$250 billion or more in total consolidated assets or \$10 billion or more in on-balance sheet foreign exposure;<sup>3</sup> and (ii) separately to depository institutions with \$10 billion or more in total consolidated assets that are consolidated subsidiaries of any such holding company (each, a “Covered Company”).

The Associations continue to support the maintenance by banking organizations of stable funding and liquidity profiles, but believe that key reforms already enacted, including the Liquidity Coverage Ratio, will ensure these profiles will remain stable over time. These regulatory changes, made since the NSFR was originally proposed in 2009, focus on many similar risks that the NSFR is meant to reduce. These intervening regulatory changes call into question whether the proposal’s purported incremental benefits would outweigh the costs that would be imposed on the U.S. economy and job growth if the NSFR is implemented as proposed. This is particularly the case in light of the adoption in the United States of many reforms that are more stringent than the Basel Committee’s post-crisis Basel III regime—including a wide range of measures aimed at similar funding and liquidity risks that the NSFR seeks to address, as discussed in greater detail in Part II of this letter.

Indeed, we note that since the recent financial crisis, including as a result of these reforms, U.S. commercial banks have made great strides in improving the duration and stability of their overall funding profiles by reducing reliance on wholesale funding, reducing net short-term funding, reducing interbank loans and increasing demand deposits.<sup>4</sup>

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<sup>2</sup> 81 Fed. Reg. 35,124 (June 1, 2016) (the “NSFR Proposed Rules”). The introduction and commentary included with the proposed rule are referred to herein as the “Preamble.” The Federal Reserve also proposed a modified version of the NSFR for certain other domestic banking organizations with total consolidated assets greater than \$50 billion but less than \$250 billion (the “Modified NSFR”).

<sup>3</sup> In addition, consistent with the approach suggested in the Federal Reserve staff memo accompanying the recently repropose Single Counterparty Credit Limits rule, we believe the calculation of on-balance-sheet foreign exposures should be clarified to exclude exposures to both the foreign bank parent and the foreign bank parent’s home country sovereign. That staff memo explains that the calculation of such exposures “exclude[s] exposure of the intermediate holding company or combined U.S. operations to both the foreign bank parent and the foreign bank parent’s home country sovereign.” This approach is appropriate because it properly reflects that the calculation of foreign exposures is in relation to exposures of the combined U.S. operations and should be set forth in the text of the final NSFR rule. Memorandum from Governor Tarullo to the Board of Governors, *Proposed rules to implement single-counterparty credit limits in section 165(e) of the Dodd-Frank Act* (Feb. 26, 2016), available at: <http://www.federalreserve.gov/aboutthefed/boardmeetings/sccl-board-memo-20160304.pdf>.

<sup>4</sup> See The Clearing House, *Assessing the Basel III Net Stable Funding Ratio in the Context of Recent Improvements in Longer-Term Bank Liquidity*, p. 5 (Aug. 2013), available at: <https://www.theclearinghouse.org/~media/files/association%20documents/20130829%20tch%20study%20assessing%20the%20base%20iii%20net%20stable%20funding%20ratio%20in%20the%20context%20of%20recent%20improvements%20in%20bank%20liquidity.pdf>.

In light of the foregoing, the Associations believe that a detailed study of the cumulative impact of existing rules and clear identification of any remaining funding or liquidity-related risks to be mitigated are warranted. At a minimum, should the Agencies nevertheless decide to move ahead with an NSFR requirement in the United States, there are several substantive and procedural concerns with the proposal that should be addressed.

First, the proposed NSFR requirement appears to lack clear and coherent conceptual and analytical bases. As first introduced by the Basel Committee in 2009, the NSFR was originally designed to serve a clear conceptual purpose: to act as a long-term complement to the LCR, with its factors calibrated as a long-term stressed metric. In originally designing the NSFR, the Basel Committee specifically noted that the “objective of the standard is to ensure stable funding on an ongoing, viable entity basis, over one year in an extended firm-specific stress scenario.”<sup>5</sup> However, in the ensuing years, the Basel Committee has discarded the stressed metric rationale for the NSFR, and neither the Basel Committee nor the Agencies have provided either an alternative justification or any underlying data and analysis to support the proposed calibration of the NSFR’s relevant factors.

This deviation by the Basel Committee and the Agencies from the original concept of the NSFR as a long-term stressed metric decouples the NSFR’s proposed calibrations from its prior analytical underpinnings.<sup>6</sup> As a result, the proposed calibration of the factors used to weight the NSFR’s key components—assets requiring stable funding, and liabilities and capital that comprise available sources of funding—would not accurately reflect a wide range of relevant information on a Covered Company’s true liquidity position.

Second, the proposal suffers from significant procedural shortcomings. The Administrative Procedure Act (the “APA”) requires that administrative agencies provide the public with the “most critical factual material” used by Federal regulatory agencies<sup>7</sup> in developing a rulemaking and requires them to consider the effect of their rulemaking on the affected industries and the broader economy. But, as we have noted, the proposal provides neither analytical support nor underlying data to support its various complex restrictions; for example, there is a notable absence of any explanation for the proposal’s treatment of derivative transactions. We believe the Agencies’ failure to do so is inconsistent with both the letter and spirit of the APA. Thus, the Agencies should release the analytical underpinnings and empirical support for the proposed rule and, at a minimum, reopen the public comment period in order to give banking organizations, market participants and other interested observers a meaningful opportunity to evaluate and comment upon these critical foundations for any NSFR framework.

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<sup>5</sup> Basel Committee, *Basel III: International framework for liquidity risk measurement, standards, and monitoring* ¶¶ 122-25 (Dec. 2010).

<sup>6</sup> See, e.g., NSFR Proposed Rules, at 35,126.

<sup>7</sup> See *Chamber of Commerce of the United States v. SEC*, 443 F.3d 890, 900 (D.C. Cir. 2006); *Appalachian Power Co. v. EPA*, 249 F.3d 1032, 1039 (D.C. Cir. 2001).

Third, were the Agencies to ultimately adopt a NSFR regime in the United States, there are numerous specific aspects of the proposed rule that require revision in order to better align the proposal's constructs with the underlying economic substance of different assets, liabilities and related transactions, to better reflect the reality of market dynamics in the United States, and to help mitigate some of the unwarranted costs and distortions that the proposed NSFR would otherwise foster.

In addition, we believe the Agencies should not implement each and every element of the Basel NSFR framework, especially those elements incorporated from the short-term stressed-based assumptions of the LCR rule and elements that have unique effects on the banking and financial system in the United States (but do not appear to have been conceived with those in mind). Rather, the Agencies should carefully consider, in the context of both the existing impact of extant U.S. capital and liquidity regulation and the unique nature of the U.S. financial system, whether adjustments and changes are required to avoid unnecessary harm to the U.S. banking sector and the broader economy, and to better tailor their application to U.S. banking organizations and financial markets, including idiosyncratic asset classes and funding sources. In light of the foregoing, we believe that the Agencies should continue to consider the evolution of the NSFR framework and revise the proposed rule to better tailor its impact and correct its substantive shortcomings.

Part I of this letter provides an executive summary of our comments; Part II discusses our concerns that the analytical and quantitative bases underlying the provisions of the proposed rule and the NSFR's corresponding calibration are not fully transparent and provide an insufficient opportunity for the public scrutiny and debate that is required by the letter and spirit of the APA; Part III sets forth our specific comments and recommendations with respect to various aspects of the proposed rule; Part IV describes our concerns that the implementation of the NSFR may have adverse consequences for U.S. consumers, small businesses and the broader economy; and Part V contains comments with respect to other aspects of the Agencies' proposal, including the proposed changes to various definitions in the existing LCR rule.

## **I. Executive Summary**

### *Overarching Concerns*

- The final design and calibration of any NSFR requirement should be established by reference to clear and coherent conceptual and analytical bases for each element of the proposed rule, which should be disclosed publicly in order to promote transparency in the rulemaking process and provide interested parties with the opportunity to provide meaningful comment.
  - The NSFR and its calibration as they currently stand do not appear to account for the cumulative impact of other regulatory requirements.

- The Agencies should not implement the Basel Committee’s NSFR Framework in the United States without an analytically sound rationale that takes into account the unique aspects of the U.S. financial system.
  - The Basel Committee’s process that led to the finalization of the international NSFR framework upon which the proposal is based lacked sufficient transparency and disclosure; the Agencies should provide empirical analysis of key elements of the NSFR under the letter and spirit of the APA.
- Were the Agencies to ultimately adopt an NSFR regime, particular areas of the proposed rule should be revised to better align with the underlying economic substance of various assets, liabilities and related transactions, better reflect the reality of market dynamics in the United States, and help mitigate some of the unwarranted costs of the NSFR.
- The Associations believe several components of the proposal’s calculation of RSF amounts for derivative transactions should be amended to correct conceptual and technical shortcomings in the proposed rule and improve the NSFR’s accuracy.
    - The calculation of the NSFR derivatives asset amount should be revised to address certain asymmetries and to more accurately capture the funding value of variation margin received.
    - The proposed rule should exclude the value of cleared derivative transactions in which a Covered Company is acting as riskless principal from the derivative asset and derivative liability amounts, in line with the treatment of agent transactions.
    - Initial margin received by the Covered Company should receive treatment under the interdependent assets and liabilities framework in certain circumstances.
    - Initial margin provided by a Covered Company should not be subject to an 85 percent RSF floor in short-dated derivatives transactions.
    - The 20 percent add-on for potential portfolio valuation changes has significant flaws and should not, in any event, be finalized without re-opening the comment period and providing additional data and analysis.
    - The U.S. NSFR should not be more stringent than the Basel NSFR Framework in respect of the 20 percent add-on by excluding settlement payments from the calculation.
  - Aspects of the proposed rule’s treatment of ASF factors should be amended, including:

- Retail brokered deposits with a maturity of greater than one year should receive a 100 percent ASF factor.
- Brokered transaction deposits should receive a 90 percent ASF factor because these deposits are nearly identical in practice to retail deposits.
- Brokered sweep deposits received from unaffiliated institutions should receive a 90 percent ASF factor, in line with brokered sweep deposits received from affiliates, to the extent that the Covered Company has priority that is comparable to the priority of an affiliate brokered sweep deposit.
- The Agencies should assign a 50 percent ASF factor to non-maturity brokered deposits that are held in a savings account, given that these deposits are substantially similar to deposits in a retail savings account from a stability perspective.
- The Agencies should not compound the already punitive treatment of operational deposits under the LCR rule by applying a 50 percent ASF haircut to operational deposits, and should instead assign a higher ASF factor to such deposits to align more closely with their treatment under the LCR rule.
- Non-deposit liabilities owed to a retail customer or counterparty with a remaining maturity of six months or less should be assigned a 50 percent ASF factor or, in the alternative, unsecured liabilities of a broker-dealer subsidiary of a Covered Company should be assigned a 50 percent ASF factor when such liabilities are owed to a retail customer or counterparty and arise in connection with a transactional account at the broker-dealer.
- Aspects of the proposed rule's treatment of RSF factors should be amended, including:
  - In calibrating RSF factors, the proposed rule incorrectly applies parameters from the LCR rule, a short-term stressed metric, which results in RSF factors that do not accurately reflect the amount of required amount of stable funding for a Covered Company across all market conditions over a one-year time horizon.
  - Subjecting repurchase agreements to asymmetric treatment under the proposed rule would unduly restrict an important funding market for BHCs.
  - The proposed rule contains conceptual inconsistencies, both internal and contrasted with the LCR, that should be eliminated.

- The proposed rule should recognize the availability of FHLB advances in stressed and unstressed environments by reducing the RSF factors that are applicable to assets that are eligible for FHLB advances or, in the alternative, assigning an ASF factor greater than 0 percent to the unused borrowing capacity from FHLBs.
  - Trade date receivables that fail to settle within the standard settlement period but that are expected to settle should be assigned a 0 percent RSF factor, in line with the treatment provided in the Basel NSFR Framework.
  - Segregated client assets should not be assigned an RSF factor greater than zero because Covered Companies do not have long-term funding obligations with respect to client assets that are held in a segregated account.
  - Commodities traded on a non-U.S. exchange should be assigned an 85 percent RSF factor, consistent with the treatment of commodities traded on a U.S. exchange.
  - The proposed rule should mirror the treatment of commitments under the LCR rule by permitting a Covered Company to take into account collateral that is received by the Covered Company to secure its commitment.
- For purposes of determining the “excess” ASF amount of a consolidated subsidiary, the Agencies should further clarify that intercompany transactions between a Covered Company and its consolidated subsidiary when such transactions qualify as regulatory capital of the subsidiary are not taken into account.
  - The Agencies should not apply the NSFR separately to the depository institution subsidiaries of a Covered Company.
  - Although the Agencies did not provide a framework for the treatment of interdependent assets and liabilities, the Associations believe that certain transactions should be eligible for more appropriate treatment under the NSFR due to their economic substance.
  - A *de minimis* exception to the requirement that a Covered Company notify the appropriate Agency of an NSFR shortfall is appropriate for the NSFR.
  - The effective date of January 1, 2018 as currently proposed does not afford Covered Companies adequate implementation time with respect to several aspects of the proposed NSFR calculation requirements.

- A Covered Company should be permitted to calculate its NSFR in the same manner as it calculates its regulatory capital requirement.
- The imposition of the NSFR may have negative consequences for the broader economy—including through the reduction in the supply of credit by banking organizations—and may add further to a deterioration in market liquidity.
- Aspects of the proposed rule’s definitions and disclosure requirements should be amended, including:
  - The definition of “Liquid and Readily-Marketable” should be revised to incorporate a straightforward, presumptions-based approach supplemented by additional analysis only for a limited pool of securities for which there is a legitimate question as to whether the security in fact has the requisite liquidity profile to be eligible HQLA.
  - The Agencies’ proposed modifications to the definitions of secured lending transaction and secured funding transaction pose several issues that should be corrected in advance of finalization of the NSFR.
  - The revised definitions of “unsecured wholesale funding” and “unsecured wholesale lending” should not be deemed to capture asset exchanges.
  - The Agencies’ Pillar 3 market discipline-related policy objectives would be better achieved by a more limited form of quantitative disclosure of NSFR information and providing Covered Companies with additional time to prepare for implementation of the proposed rule’s disclosure requirements.

**II. The final design and calibration of any NSFR requirement should be established by reference to clear and coherent conceptual and analytical bases for each element of the proposed rule, which should be disclosed publicly in order to promote transparency in the rulemaking process and provide interested parties with the opportunity to provide meaningful comment.**

**A. The NSFR and its calibration as they currently stand do not appear to account for the cumulative impact of other regulatory requirements.**

When the NSFR was first proposed by the Basel Committee in December 2009<sup>8</sup> and then revised in December 2010,<sup>9</sup> the metric was designed to ensure that a banking organization with

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<sup>8</sup> See Basel Committee, *Consultative Document: International framework for liquidity risk measurement, standards and monitoring* (Dec. 2009).

<sup>9</sup> See Basel Committee, *Basel III: International framework for liquidity risk measurement, standards and monitoring* (Dec. 2010).



an NSFR above one would be able to withstand a one-year episode of idiosyncratic liquidity stress. This original design was intended to function as a complement to the LCR rule, which was proposed simultaneously, and which was designed to ensure that a banking organization could withstand a 30-day period of severe idiosyncratic and market-wide liquidity stress. In the initial Basel proposal for the NSFR, “available stable funding” (“ASF”) was defined as “reliable sources of funding over a one-year time horizon under conditions of extended stress” and “required stable funding” (“RSF”) was defined as “the approximate amount of a particular asset that could not be monetized through sale or use as collateral . . . during a liquidity event lasting one year.”<sup>10</sup> This construct made good sense, and would have allowed for development of a cogent proposed rule and for meaningful comment on such a rule—similar to the cogency and process of the LCR.

However, the final Basel NSFR standard published in October 2014,<sup>11</sup> as well as the current proposed rule, no longer relies on the concept of the NSFR as a measure of the stability of a Covered Company’s funding profile based on a stressed scenario. The ASF and RSF factors are now intended to measure the stability of a Covered Company’s longer-term funding across “all market conditions,” and the proposed rule specifically states that ASF and RSF factors are not intended to be calibrated based solely on a market stress environment.<sup>12</sup>

The original concept of the NSFR required that the one-year stress scenario upon which it was calibrated be less intense than the 30-day episode on which the LCR rule was based to avoid redundancy with the LCR rule given the NSFR’s longer time horizon. To our knowledge, neither the Basel Committee nor the Agencies have publicly articulated any conceptual underpinnings for this new version of the NSFR in a meaningful way.

Moreover, this lack of a well-defined analytical and policy rationale for the NSFR is exemplified by the fact that it is not at all clear what funding and liquidity risks have been left unaddressed by existing regulations promulgated by the Agencies and thus in need of further regulation through the NSFR. In particular, the Agencies have put in place multiple new measures, including a requirement that banking organizations conduct, on a monthly basis, liquidity-related stress tests across at least overnight, 30-day, 90-day, and one-year horizons, which address concerns very similar, if not identical, to the NSFR. These measures also include requirements to establish liquidity risk tolerances, review the liquidity risks of business lines and products, create cash-flow projections over short- and long-term horizons, and adopt contingency funding, each of which addresses the stability of a banking organization’s funding on an institution-specific basis. Additionally, the Agencies have implemented a wide range of other measures aimed at similar liquidity risks in banking organizations to those the NSFR is attempting to address, including: (i) a more stringent version of the LCR than was published by the Basel Committee; (ii) the Federal Reserve’s Comprehensive Liquidity Analysis and Review

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<sup>10</sup> *Id.* at ¶ 12.

<sup>11</sup> Basel Committee, *Basel III: The net stable funding ratio* (Oct. 2014).

<sup>12</sup> NSFR Proposed Rules, at 35,135.

framework (“CLAR”), which assesses the liquidity positions of certain large banking organizations; and (iii) the Method 2 surcharge calculation methodology in the U.S. implementation of the G-SIB surcharge (the “G-SIB Surcharge”) that incorporates measures of banking organizations’ reliance on short-term funding. Many of these measures are more stringent than the corresponding international frameworks published by the Basel Committee. Thus, intervening regulatory changes since the initial NSFR framework was published by the Basel Committee may have made the NSFR redundant in important respects and, at minimum, call into question from a policy perspective whether the proposal’s purported incremental benefits outweigh its considerable costs if implemented as proposed.

We are thus concerned that the proposal does not provide unambiguous answers to two fundamental policy questions: (1) what perceived problem is the NSFR meant to address; and (2) has the underlying problem—once clearly defined—been otherwise largely addressed through other regulatory initiatives? Without clear answers to both of these questions, it is difficult for market participants and other interested parties to comment on the proposed rule, particularly its calibration. The NSFR’s impact on the real economy may be substantial. Absent a well-defined conceptual underpinning for the proposed rule against which to measure its costs, it is impossible to assess whether the likely economic costs of the proposed rule are outweighed by its potential incremental benefits.

**B. The Agencies should not implement the Basel Committee’s NSFR Framework in the United States without an analytically sound rationale that takes into account the unique aspects of the U.S. financial system.**

The Agencies should not implement in the United States every element of the Basel NSFR Framework without careful consideration and a sound rationale that accounts for the unique aspects of the U.S. financial system. The adoption of most elements of the Basel NSFR Framework by the Agencies—including, in particular, with respect to the concepts incorporated from the short-term stressed-based assumptions of the LCR rule—would introduce internal inconsistencies within the NSFR framework itself and therefore result in inappropriately calibrated ASF and RSF factors. In addition, doing so would also ignore the nature of certain asset classes and funding sources that are idiosyncratic to the banking and financial system in the United States, thereby further exacerbating the NSFR’s failure to accurately reflect banking organizations’ funding and liquidity positions.

In several instances the proposed rule counterintuitively treats assets and liabilities in a manner that is more onerous than their treatment under the LCR, even though the LCR rule is calibrated based on a scenario of severe stress over a period of 30 days. For example, U.S. Treasury securities with maturities greater than one year have an RSF of 5 percent in the NSFR, indicating that only 95 percent of the securities could be sold or repoed over a one-year time horizon in “all market conditions.” However, the LCR rule assumes that 100 percent of such Treasury securities could be sold or repoed over a *30-day* period of severe market stress. These inconsistencies were introduced in the October 2014 Basel Committee final revision and have

been incorporated wholesale into the proposed rule without any discussion of the merits of this differential treatment or the provision of relevant data to confirm the assumptions.

Furthermore, certain assets and funding sources are particular to the financial system in the United States. As set forth in further detail below, these assets and funding sources, such as the Federal Home Loan Bank (“FHLB”) advances and agency mortgage-backed securities (“Agency MBS”), should be subject to careful analysis of more appropriate ASF and RSF factors in light of the idiosyncrasies of the U.S. financial system and should not be assigned ASF and RSF factors based solely on the treatment in the Basel NSFR Framework of items that facially appear to be similar but, in practice, function quite differently in U.S. markets.

**C. The Basel Committee’s process that led to the finalization of the international NSFR framework upon which the proposal is based lacked sufficient transparency and disclosure; the Agencies should provide empirical analysis of key elements of the NSFR under the letter and spirit of the APA.**

Despite the fact that the NSFR was first proposed by the Basel Committee in 2009, key elements of the 2014 final Basel NSFR Framework were never proposed in earlier NSFR consultations and therefore were not subject to consideration and deliberation by outside parties. Instead, these provisions appear to have been developed and added to the Basel NSFR Framework without public input or the publication of data or evidence supporting the revisions:

- Most significantly, applying a 100 percent RSF factor to 20 percent of the gross derivative liabilities of a subject banking organization (calculated without taking into account any variation margin provided with respect to derivatives transactions).
- Assigning a 10 or 15 percent RSF factor to short-term loans to banking organizations and thereby effectively imposing a tax on repurchase and related transactions by banking organizations, in comparison to the Basel consultative documents, which assigned a 0 percent RSF for these transactions.
- Assigning an 85 percent RSF factor (or higher) for initial margin provided to a counterparty to a derivatives transaction; the Basel consultative documents did not assign an RSF factor to initial margin provided.
- Assigning an 85 percent RSF factor (or higher) for contributions to central counterparty (“CCP”) default funds; the consultative document did not assign an RSF factor to contributions to a CCP’s default fund.
- Treating NSFR derivatives assets asymmetrically from NSFR derivatives liabilities by imposing requirements on the type of variation margin received that reduces the former but not on the type of variation margin provided that reduces the latter; the

Basel Committee's consultative document did not impose requirements on variation margin received.

We are concerned that the lack of transparency in the Basel Committee's process for finalizing the NSFR has led to a framework—that is reflected in the proposed rule—which has not been subject to the obvious benefits of full and deliberate consideration by a wide range of interested parties, not just the regulatory bodies that happen to be represented on the relevant groups within the Basel Committee. We firmly believe that the Basel process is at its strongest where material elements of proposals are first presented in consultation and subject to rigorous public scrutiny. Indeed, the Basel Committee has significantly modified various initiatives in light of public comments received.<sup>13</sup> Moreover, as the revisions adopted by the Basel Committee in the final Basel NSFR Framework were not incorporated into its NSFR data collection exercise, it is not at all clear how the Basel Committee would have been able to analyze important quantitative data for the purpose of making decisions regarding material elements of the Basel NSFR Framework that were adopted in the final standard.<sup>14</sup> In the case of the 20 percent RSF factor add-on for gross derivatives liabilities, for example, the Basel Committee incorporated problematic provisions in the final Basel NSFR Framework that were not included in its consultative documents without being able to fully analyze the quantitative impact of these elements on banking organizations and relevant markets.

We note that supervisors in other major jurisdictions have decided to review issues that were not subject to consultation in the Basel process before proceeding with an implementation rulemaking. The European Commission (the "EC"), for example, has requested that the European Banking Agency (the "EBA") examine several of these "key" issues, citing the lack of effective consultation during the development of the global standard.<sup>15</sup> The EC has similarly raised these matters with the EBA to determine whether the impact of the NSFR on the European economy has been adequately considered and issued a public consultation, seeking further quantitative input and technical comments.<sup>16</sup>

As such, we respectfully urge the Agencies to approach these provisions with particular scrutiny and encourage the Agencies to conduct a similar exercise in the United States evaluating

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<sup>13</sup> See, e.g., Basel Committee, *Interest rate risk in the banking book* (Apr. 2016).

<sup>14</sup> Basel Committee, *Basel III Monitoring Report*, p. 4 (Mar. 2015) ("Given data collected as part of the end-June 2014 reporting period was obtained prior to the release of the revised standard, certain revisions adopted in the revised standard have not yet been incorporated into the NSFR data collection exercise. As such, this report provides analysis of results under the standard outlined in the NSFR consultative paper (CP) issued by the Basel Committee in January 2014 and not the standard approved by the Committee in October 2014.").

<sup>15</sup> Letter from Marie Deval and Olivier Guersent, EC, to Andrea Enria, EBA, p. 2 (Apr. 12, 2016).

<sup>16</sup> EC, *DG FISMA Consultation Paper: On further considerations for the implementation of the NSFR in the EU* (May 2016).

whether the proposed rule accurately captures the funding risk profile of banking organizations in a capital markets-intensive economy such as the United States.

In the United States, the APA requires that a notice of proposed rulemaking include “either the terms or substance of the proposed rule or a description of the subjects and issues involved.”<sup>17</sup> After issuing a notice, the agency must “give interested persons an opportunity to participate in the rule-making through submission of written data, views, or arguments with or without opportunity for oral presentation.”<sup>18</sup> Courts have interpreted APA notice-and-comment procedures to require an agency to reveal “the ‘technical studies and data’ upon which the agency relies” for public evaluation.<sup>19</sup> Where an agency fails to disclose such “studies and data,” and an affected party is thereby “prejudiced by the absence of an opportunity” to comment meaningfully, the agency action must be vacated.<sup>20</sup> Public release of this information is mandated by the APA and applicable case law, which generally require—to enhance the public’s participation in rulemakings—that the public be provided the “most critical factual material”<sup>21</sup> used by the Agencies in developing a rulemaking.<sup>22</sup> Moreover, the requirements of the APA must be observed even with respect to those elements of the proposed rule that have been adapted from the Basel NSFR framework. It should not be the case that the Agencies consider themselves obligated to administer each and every element of regulatory standards that are negotiated and finalized by international bodies before a single rulemaking, notice, or other public administrative process relating to that standard has commenced in the United States. This is particularly important given the lack of any public record or other details regarding how decisions were actually reached by the Basel Committee in promulgating its final standards and related calibration.

As part of the proposal, the Agencies have not included any empirical analysis of various key elements of the NSFR. For example, like the Basel Committee, the Agencies have failed to provide the data relied upon by the Agencies in adopting the 20 percent RSF factor add-on for gross derivatives liabilities. Although the Agencies explain that, in considering the appropriate measure to account for this risk, they determined that the additional 20 percent factor “falls

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<sup>17</sup> 5 U.S.C. § 553(b)(3).

<sup>18</sup> 5 U.S.C. § 553(c).

<sup>19</sup> *Chamber of Commerce*, 443 F.3d at 899; *see also Am. Radio Relay League v. FCC*, 524 F.3d 227, 236 (D.C. Cir. 2008); *Nova Scotia Food Prods. Corp.*, 568 F.2d at 251 (agency’s failure to disclose underlying data prevents public “criticism of the methodology used or the meaning to be inferred from the data”).

<sup>20</sup> *Owner-Operator Indep. Drivers Ass’n v. FMCSA*, 494 F.3d 188, 202 (D.C. Cir. 2007); *see also Cal. Wilderness Coal. v. U.S. Dep’t of Energy*, 631 F.3d 1072, 1095 (9th Cir. 2011) (“[W]here a regulation is promulgated in violation of the APA and the violation is not harmless, the remedy is to invalidate the regulation.”).

<sup>21</sup> *See Chamber of Commerce of the United States v. SEC*, 443 F.3d 890, 900 (D.C. Cir. 2006); *Appalachian Power Co. v. EPA*, 249 F.3d 1032, 1039 (D.C. Cir. 2001).

<sup>22</sup> *State Farm*, 463 U.S. at 43 (internal quotation marks omitted); *Business Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011).

within the range of observed volatility,” the Agencies did not provide any data that would allow the public to: (i) test the Agencies’ conclusion that the 20 percent add-on falls within the range of observed volatility; (ii) know the period of observation; (iii) identify *where* within the range of observed volatility the 20 percent multiplier falls; (iv) determine whether a differently calibrated multiplier would also fall within the range of observed volatility; or (v) identify whether the firms represented in the Agencies’ data are representative of the market as a whole.

Similarly, there does not appear to be a clear empirical foundation for the treatment of off-balance sheet collateral in the proposed rule, which requires a Covered Company in certain circumstances to assign an RSF factor to off-balance sheet collateral “as if” such collateral were included in the Covered Company’s balance sheet and goes well beyond the corresponding provision in the Basel NSFR Framework. It is unclear which, if any, existing data sources would have been available to the Agencies to estimate the potential impacts to the U.S. banking industry under the criteria described in Section 106(d) of the proposed rule.

The significant potential impact of the proposed rule, as described above, makes it imperative that the Agencies provide transparent and complete details of the underlying rationale of this calculation. Consistent with the letter and spirit of the APA, the Agencies should therefore release the relevant information and analytical bases relied upon in the proposal, including by: (i) clearly and publicly defining the conceptual underpinnings and regulatory objectives of the NSFR; (ii) disclosing the empirical underpinnings and related analyses of the NSFR framework (such as with respect to the elements that lacked transparency at the international level); (iii) examining the alternative initiatives in the current regulatory framework that address the liquidity and funding profiles of U.S. banking organizations; and (iv) fully weighing the considerable costs of implementing the NSFR in the United States against the purported benefits, and should, at minimum, reopen those elements of the proposed rule affected by or related to this information for public comment.

**III. Were the Agencies to ultimately adopt an NSFR regime, particular areas of the proposed rule should be revised to better align with the underlying economic substance of various assets, liabilities and related transactions, better reflect the reality of market dynamics in the United States, and help mitigate some of the unwarranted costs of the NSFR.**

**A. Derivatives**

The Associations believe several components of the proposal’s calculation of RSF amounts for derivative transactions should be amended to correct conceptual and technical shortcomings in the proposed rule and improve the NSFR’s accuracy. If these shortcomings are not addressed in any final rule, we believe that the NSFR’s reliance on a fundamentally erroneous methodology for measuring the funding requirements of Covered Companies’ derivatives activities would create substantial incremental costs for offering such products, resulting in reduced liquidity for derivatives, increased market volatility, and leading to

ultimately increased prices of goods and services in the real economy, as described in more detail in Part IV below.

**1. The calculation of the NSFR derivatives asset amount should be revised to address certain asymmetries and to more accurately capture the funding value of variation margin received.**

Under the proposed rule, NSFR derivative asset amounts would be reduced only by *certain* types of variation margin received, but NSFR derivative liability amounts would be reduced by *any* type of variation margin provided. Specifically, in order to reduce NSFR derivatives asset amounts, variation margin received would need to satisfy the requirements to be treated as a pre-settlement payment under the supplementary leverage ratio (“SLR”), including that the variation margin must be:

- in the form of cash in the same currency as the settlement currency;
- the “full amount that is necessary to fully extinguish the net current credit exposure to the counterparty of the derivative contracts”; and
- calculated and exchanged on a daily basis.

In contrast, *any* variation margin—whether in the form of cash or securities, and whether the full amount necessary to extinguish the exposure or a partial amount—would reduce NSFR derivatives liability amounts from a substantive economic perspective.

As a threshold matter, the Agencies have not articulated a sound reason for this inconsistent and asymmetrical treatment of variation margin. The Agencies state that the asymmetry is “to prevent understatement of the Covered Company’s derivatives RSF amount”<sup>23</sup>—in other words, as a measure of conservatism. We do not believe it is appropriate for the Agencies to add an arbitrary measure of conservatism after measuring actual risks, let alone to then include a second arbitrary layer of conservatism, which the proposal would do for derivatives by also including an add-on for potential future changes in portfolio value, discussed below.

In addition, the Agencies introduced strict criteria for qualifying variation margin in the SLR context for a specific reason. According to the Agencies, the SLR “generally does not permit banking organizations to use collateral to reduce exposures for purposes of calculating leverage exposure,” and therefore the strict criteria ensure that qualifying variation margin could be characterized “in substance, [as] a form of pre-settlement payment” rather than as collateral.<sup>24</sup> This reasoning does not apply in the context of the NSFR, which recognizes collateral as reducing a Covered Company’s funding risk regardless of its characterization. While the SLR is

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<sup>23</sup> NSFR Proposed Rules, at 35,150.

<sup>24</sup> 79 Fed. Reg. 57,725, 57,730 (Sept. 26, 2014).

intended to be a backstop that ignores risk completely and treats all assets the same, the NSFR plainly weighs the liquidity risk of a Covered Company's balance sheet assets. Thus, as a general matter, it is inappropriate for the NSFR to include standards created specifically to address the SLR.

In this context, we believe the Agencies should consider: (i) four modifications to the proposed rule, as set forth below, to resolve the asymmetry problem and better capture the funding value of variation margin received by a Covered Company; and (ii) a change to the calculation of NSFR derivatives asset amounts—taking the tenor of derivatives into account—to improve the accuracy and consistency of the NSFR. We believe these proposed modifications would more accurately reflect the funding value of variation margin and would align the treatment of derivatives asset amounts with the treatment of non-derivatives assets and liabilities by taking into account remaining maturity.

**a. Variation margin in the form of Level 1 HQLA securities should qualify to reduce NSFR derivatives asset amounts.**

As the Agencies recognize in the proposed rule, securities that are Level 1 high-quality liquid assets (“HQLA”) have minimal liquidity and market risk.<sup>25</sup> The LCR recognizes that these securities are so liquid and creditworthy that they should not receive “haircuts” or otherwise be discounted in a 30-day severe stress scenario.<sup>26</sup> Recognition of the funding value of variation margin in the form of Level 1 HQLA would also be conceptually consistent with other parts of the NSFR that assign a lower RSF factor to assets when they are collateralized by Level 1 securities. For instance, secured lending transactions with a financial sector entity that mature within six months would generally receive a 15 percent RSF if secured by assets other than re-hypothecable Level 1 HQLA, but would receive only a 10 percent RSF if secured by re-hypothecable Level 1 HQLA.<sup>27</sup> Additionally, Level 1 HQLA held on a Covered Company's balance sheet would receive a 5 percent RSF factor while Level 2A HQLA and Level 2B HQLA would receive 15 percent and 50 percent RSF factors, respectively.

Non-recognition of Level 1 HQLA would also create a basic inconsistency between the Agencies' margin rules, which are intended to promote the safety and soundness of prudentially regulated swap entities, and the NSFR. While the Agencies' 2014 proposed rulemaking on margin would have required banking organizations to exchange variation margin exclusively in

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<sup>25</sup> NSFR Proposed Rules, at 35,142 (describing Level 1 securities' “high credit quality and favorable market liquidity characteristics, which reflect their ability to serve as reliable sources of liquidity. For example, U.S. Treasury securities (a form of Level 1 HQLA) have among the highest credit quality of assets because they are backed by the full faith and credit of the U.S. government. In addition, the market for U.S. Treasury securities has a high average daily trading volume, large market size, and low bid-ask spreads relative to the markets in which other asset classes trade.”).

<sup>26</sup> LCR rule § 21(b)(1).

<sup>27</sup> See NSFR Proposed Rules § 106(a)(3).



cash with financial end users,<sup>28</sup> in the 2015 final rulemaking “the Agencies . . . concluded that it is appropriate to permit financial end users to use other, non-cash forms of collateral for variation margin.”<sup>29</sup> As such, the Agencies’ own margin requirements expressly recognize that banking organizations can and will collect non-cash variation margin from end users, and that such variation margin is a valid form of collateralization for derivatives. There appears to be no rational basis for concluding that end users’ non-cash collateral is valid collateralization within the margin framework but invalid collateralization for NSFR purposes. In fact, strict margin eligibility criteria in the NSFR rule could create a *de facto* market requirement for end users to post variation margin only in the form of cash, given the material disparity in RSF for a collateralized derivative asset amount versus an uncollateralized derivative asset amount. Such a requirement would contradict and undermine the Agencies’ decision that it is appropriate for financial end users to use non-cash variation margin as a matter of regulating the safety and soundness of swap entities. Because the NSFR will end up driving market behavior, the Agencies should formulate any criteria for variation margin carefully in the NSFR context to address actual liquidity risks, rather than automatically importing the SLR variation margin criteria when there is no liquidity rationale for doing so.

Moreover, clients that post variation margin in the form of securities would be unfairly and disproportionately penalized by a strict cash requirement—that is, the NSFR would strongly incentivize Covered Companies to increase fees for and reduce transaction volumes with those clients where transactions would generate higher RSF charges, as would be the case where variation margin is posted in the form of securities. Notably, mutual funds and pension funds commonly post highly liquid securities variation margin when entering into derivatives to hedge their investment risks because they rely on cash equivalents rather than cash. As a result of the proposed rule’s treatment of cash equivalent variation margin, these clients’ transactions would carry significantly higher RSF charges than other clients’ transactions, which could in turn lead to less favorable fee rates and reduced access to derivatives for these clients absent changes to their margin practices. Therefore, the proposed rule, if not amended to recognize the funding value of Level 1 securities, would inappropriately force mutual funds and pension funds to alter their treasury strategies to accommodate the ability to post margin in cash rather than cash equivalents. If these firms were unable to do so due to some combination of risk management or regulatory constraints, this requirement of the proposed rule would ultimately reduce returns for retail investors and pensioners.

*Annex B* to this letter includes an example illustrating how derivatives assets and liabilities would be calculated after modifying the proposal to recognize the funding value of securities variation margin.

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<sup>28</sup> See Agencies’ Margin Proposed Rule § 6(a)(1), 79 Fed. Reg. 57,348, 57,392 (Sept. 24, 2014).

<sup>29</sup> 80 Fed. Reg. 74,840, 74,866 (Nov. 30, 2015); see also Agencies’ Margin Final Rule § 6(b) (permitting the exchange of non-cash variation margin with financial end users).

**b. Variation margin should qualify to offset derivatives asset amounts even if it is denominated in a different currency than the settlement currency.**

The proposal offers no explanation as to why variation margin denominated in a different currency than the currency of settlement should not be eligible to offset derivative asset amounts. To the contrary, in every other part of the NSFR framework, the proposed rule would treat collateral denominated in a different currency than the asset the same as collateral denominated in the same currency as the asset. Moreover, the LCR also treats foreign currency as a source of liquidity and includes foreign withdrawable reserves as Level 1 HQLA, stating that such reserves “should be able to serve as a medium of exchange in the currency of the country where they are held.”<sup>30</sup> Similarly, the LCR includes publicly traded equities as Level 2B HQLA where they are issued in a currency of a jurisdiction in which a banking organization operates.<sup>31</sup> Variation margin denominated in the currency of any jurisdiction in which a Covered Company operates is a valid source of funding for the Covered Company, and should thus qualify to offset derivatives assets amounts.

**c. Variation margin should qualify to offset derivatives asset amounts even if it is not the full amount necessary to fully extinguish the Covered Company’s net current credit exposure.**

The proposal would import the SLR standard for recognition of variation margin, which requires that the margin be the “full amount that is necessary to fully extinguish the net current credit exposure to the counterparty of the derivative contracts.” We see no justification for this requirement. Variation margin actually provided to the Covered Company reduces the Covered Company’s asset amount and associated funding requirement regardless of whether it is the full amount necessary to extinguish the Covered Company’s current exposure. All variation margin received is equally valid as a source of funding for the Covered Company, no matter its amount relative to the size of the derivative transaction or asset amount.

We also note that the Basel Committee’s April leverage ratio consultative document would change the criteria for recognition of variation margin for purposes of the leverage ratio. Under that consultation, the Basel standard would no longer require the margin to “fully” extinguish a banking organization’s current exposure to qualify to reduce the value of the banking organization’s current exposure.<sup>32</sup> Assuming that this element of the consultation is finalized as proposed, the proposed rule would then be more stringent than the Basel NSFR Framework if the Agencies choose not to conform their interpretation of the U.S. SLR rule to the Basel leverage ratio interpretation with respect to cash variation margin.

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<sup>30</sup> 79 Fed. Reg. 61,440, 61,456 (Oct. 10, 2014).

<sup>31</sup> LCR Rule at § 20(c)(ii)(2).

<sup>32</sup> Basel Committee, *Consultative Document: Revisions to the Basel Leverage Ratio Framework*, p. 7, Annex ¶ 24(iv) (Apr. 2016).

**d. Variation margin should qualify to offset derivatives asset amounts even if it is posted less frequently than daily.**

The SLR standard for recognition of variation margin requires that the margin be calculated and transferred on a daily basis based on the mark-to-fair-value of the derivative contract. However, ignoring margin received by a Covered Company in the NSFR context based solely on the fact that it is posted less frequently than on a daily basis makes no sense from a funding perspective. Variation margin reduces the Covered Company's asset amount and associated funding requirement as long as it has been posted to the Covered Company. The Associations therefore believe that this requirement should not be included in any final NSFR standard.

**e. NSFR derivatives asset amounts should reflect the remaining maturity of derivatives.**

The proposed rule's calculation of NSFR derivatives asset amounts is also inconsistent with a fundamental precept of the NSFR—that is, taking remaining maturity into account in determining appropriate RSF and ASF factors.<sup>33</sup> In fact, for non-derivatives assets and liabilities, remaining maturity is one of the principal drivers of the calibration of RSF and ASF factors.

Under the proposal, all derivatives that are “in the money” for the Covered Company—whether maturing in one week or 10 years—would require the same degree of long-term funding. In reality, short-dated derivatives do not require as much long-term funding as long-dated derivatives. The Covered Company could allow short-dated derivatives to mature rather than rolling them over into new transactions, just as it could with non-derivative assets. In addition, there is no market or client expectation that Covered Companies would roll over derivatives transactions in the manner the Agencies have identified for certain lending transactions.<sup>34</sup> And even if they were rolled over, new transactions would occur at the then-prevailing market prices and would not give rise to an on-balance sheet asset or liability. Even for lending transactions, the proposed rule nevertheless applies higher RSF factors to 10-year loans than one-week loans. The tenor of derivatives should thus be taken into account in a similar manner in calculating NSFR derivatives asset amounts.

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<sup>33</sup> See, e.g., Basel NSFR Framework ¶ 14(c) (“The NSFR assumes that some short-dated assets (maturing in less than one year) require a smaller proportion of stable funding because banks would be able to allow some proportion of those assets to mature instead of rolling them over.”).

<sup>34</sup> NSFR Proposed Rules, 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.”).

There are well-established methodologies for measuring the remaining maturity of derivatives in the Agencies' capital regulations that could be adapted for this purpose. Specifically, the Agencies' capital rules describe how banking organizations must measure the remaining maturity of derivative netting sets.<sup>35</sup> As such, advanced approaches banking organizations already calculate derivative maturities of netting sets for purposes of their capital requirements, and that same methodology could be relied upon for NSFR calculation purposes as well.

Following the logic and structure of the broader NSFR framework, we believe that the RSF factor applicable to the net derivative asset amount should be adjusted to reflect the remaining maturity of the underlying derivative or netting set, consistent with the maturity calculation methodology utilized in the U.S. capital rules. For example, the RSF factor applicable to derivative assets could be adjusted consistent with the table below:

<b>Remaining Contractual Maturity of Derivative or Netting Set</b>	<b>Maturity Adjustment</b>
6 months or less	50%
More than 6 months but less than or equal to 12 months	75%
More than 12 months	100%

Some small adjustments to the U.S. Basel III calculation methodology may be necessary to address the specific features of the NSFR. For example, open maturity derivatives could be assigned a minimum maturity of three months, consistent with other standards in the capital framework,<sup>36</sup> and the maturity buckets would need to clearly delineate between 0-6 months, 6-12 months, and greater than 12 months' remaining maturity.

As an alternative method that would achieve a similar result, the NSFR could scale the RSF factors for an asset purchased by a Covered Company as a hedge to the underlying of a derivative.<sup>37</sup> Once the derivative matured, the Covered Company would liquidate the hedge asset, with the result that the hedge asset would have an *effective* maturity equal to the remaining maturity of the derivative. Therefore, the RSF scalar for the hedge asset would be based on the remaining maturity of the derivative. We urge the Agencies to adopt one of these proposed alternatives to taking remaining maturity into account in determining appropriate RSF and ASF factors, which would align the NSFR treatment of derivatives with non-derivatives assets and liabilities.

<sup>35</sup> See, e.g., 12 C.F.R. § 217.132(d)(4).

<sup>36</sup> See Basel Committee, *Fundamental Review of the Trading Book* ¶¶ 147-49 (Jan. 2016).

<sup>37</sup> This approach is described in more detail in the June 28, 2016 letter to the European Commission from the Association for Financial Markets in Europe, the International Swaps and Derivatives Association, and the Institute of International Finance, available at: <https://www.iif.com/publication/regulatory-comment-letter/iifisdaafme-response-european-commission-consultation-nsfr>.

**2. The proposed rule should exclude the value of cleared derivative transactions in which a Covered Company is acting as riskless principal from the derivative asset and derivative liability amounts, in line with the treatment of agent transactions.**

The proposed rule correctly provides that the value of a cleared derivative transaction that a Covered Company, acting as agent, has submitted to a CCP on behalf of the Covered Company's customer would not be included in the Covered Company's NSFR derivative asset or NSFR derivative liability amounts. The proposal would wrongly distinguish these agency transactions, however, from back-to-back, client-driven transactions, even where due to contractual provisions the funding risk to the Covered Company would be the same.

When a Covered Company stands between its customer and a CCP as a riskless principal, the funding risk to the Covered Company will typically be no different than when a Covered Company acts as an agent to submit a customer's transaction to a CCP. This is because in the circumstances where a Covered Company acts as a riskless principal, the contractual agreement between the Covered Company and its customer will generally provide that the Covered Company is required to make a payment to the customer only if the Covered Company has received a corresponding payment from the CCP. Consequently, under such a riskless-principal arrangement, where the customer is "in the money" on a transaction, the Covered Company will have no legal obligation to make a payment to the customer unless and until a corresponding payment has been received by the Covered Company from the CCP. When a Covered Company's customer is "out of the money," it is true that a Covered Company standing between the customer and the CCP as riskless principal would be obligated to make any required payment to the CCP, even if the Covered Company's customer failed to make a corresponding payment to the Covered Company. This obligation of the Covered Company, however, arises wholly from the Covered Company's status as a clearing member of the CCP and the rules of the CCP, which typically require clearing members to guarantee the performance of their customers to the CCP. Furthermore, as recognized by the Agencies, this obligation to the CCP exists regardless of whether a Covered Company stands between a customer and a CCP as agent or as riskless principal.<sup>38</sup>

Because the funding risk to a Covered Company is no different where a Covered Company acts as agent and where a Covered Company acts in a riskless-principal capacity as described above, customer cleared derivative transactions for which a Covered Company acts as such a riskless principal between a customer and a CCP should not be included in the Covered Company's NSFR derivative asset or NSFR derivative liability amounts.

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<sup>38</sup> The Agencies note that the value of a customer cleared derivative transaction where a Covered Company acts as agent would not be included in the Covered Company's NSFR derivative asset or liability amounts, "including when the covered company has provided a guarantee to the CCP for the performance of the customer." NSFR Proposed Rules, at 35,152.

**3. Initial margin received by the Covered Company should receive treatment under the interdependent assets and liabilities framework in certain circumstances.**

The proposed rule would assign no ASF value and recognize no offset to RSF for re-hypothecable initial margin received from counterparties, even though such initial margin can be used as an actual funding source by a Covered Company under applicable regulations in certain limited contexts. Specifically, such initial margin can be used to fund the Covered Company's purchase of assets that will serve as a hedge to the derivatives position as a matter of prudent asset-liability management ("ALM") practice—reducing the Covered Company's actual funding requirement for the derivative asset. As set forth in greater detail in Part III.F of this letter, such transactions should be appropriately recognized as creating "interdependent assets and liabilities" or, in the alternative, other adjustments should be made to reflect the genuine funding value such initial margin provides to derivatives-related hedge securities.

**4. Initial margin provided by a Covered Company should not be subject to an 85 percent RSF floor in short-dated derivatives transactions.**

The proposed rule would subject initial margin provided by a Covered Company to an 85 percent RSF floor, regardless of the maturity of the trade or the characteristics of the margin, "based on the assumption that a Covered Company generally must maintain its initial margin . . . in order to maintain its derivatives activities."<sup>39</sup> However, this assumption is unfounded for short-dated derivative transactions because, in the event of any liquidity concerns that emerge at the time of maturity, banking organizations can (and often do) choose not to re-enter into such transactions. For derivatives with a short remaining maturity, the Covered Company is able to liquidate the initial margin provided in a short period of time, when the contract terminates. As a result, the proposed rule should not treat such initial margin differently from other short-dated transactions that have a low expectation of rollover.

As one potential alternative to address this concern, the Agencies could provide differential RSF floors based on the maturity of the transaction or netting set:

<b>Remaining Contractual Maturity of Derivative or Netting Set</b>	<b>RSF Floor for Initial Margin Associated With Derivative or Netting Set</b>
6 months or less	15%
More than 6 months but less than or equal to 12 months	50%
More than 12 months	85%

<sup>39</sup> NSFR Proposed Rules, at 35,152.

Maturity profiles could then be attributed to pools of initial margin consistently with the Agencies' capital rules<sup>40</sup> such that the Covered Company would be able to calculate the remaining maturity of a netting set as per such rules and use that remaining maturity to determine whether the pool of initial margin associated with the netting set should be subject to the 85 percent RSF floor or to a lower number.

**5. The 20 percent add-on for potential portfolio valuation changes has significant flaws and should not, in any event, be finalized without re-opening the comment period and providing additional data and analysis.**

The proposed rule would require an RSF charge for derivatives portfolio potential valuation changes equal to 20 percent of a Covered Company's gross derivative liability values, *i.e.*, the value to the Covered Company of its derivative liabilities, calculated as if no variation margin had been exchanged and no settlement payments had been made. According to the Agencies, this add-on is intended to address the risk that a Covered Company may be required to post variation margin or make settlement payments to its counterparty based on future valuation changes to its derivatives positions.

As a *substantive* matter, the proposed rule's 20 percent add-on for potential portfolio valuation changes is seriously flawed:

- The Agencies have not established any empirical correlation between a Covered Company's gross derivatives liabilities and potential future changes in derivatives values. In fact, there is no reason to believe that the gross value of a derivative is an indicator of the contingent funding risk the derivative presents to the Covered Company;
- The add-on would not be risk-based, but rather would apply equally to lower-volatility derivatives and higher-volatility derivatives even though there is by definition less risk of the Covered Company being required to post variation margin or settlement payments for a lower-volatility derivative;
- The use of gross derivatives liability values would result in different treatment of transactions for NSFR purposes based on the time the Covered Company entered into them even if such transactions were economically identical in terms of funding risk. Gross derivatives values reflect the relative value of a derivative's reference asset at the present time compared to its value at the time the Covered Company entered into the transaction, not the actual funding risk of the derivative to the Covered Company at the present time once variation margin has been exchanged at mark-to-market values. Two derivatives could present identical funding risk to the Covered Company at the present time, but if the Covered Company entered into them at different times

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<sup>40</sup> See, *e.g.*, 12 C.F.R. § 217.132(d)(4).

- in the past, their gross derivatives values could be different from each other, and therefore would result in different RSF charges under the proposed rule;
- The add-on would incentivize Covered Companies to close out transactions and enter into identical transactions to reset their gross liability amounts, even though such reset transactions would not change a Covered Company's actual funding risk;
  - The use of gross derivatives liability values assumes that all derivatives require a Covered Company to post variation margin or make settlement payments. However, un-margined derivatives have no such requirement and therefore present no risk of the Covered Company being required to post variation margin or make settlement payments as prices move against the Covered Company;
  - Derivatives assets and liabilities both tend to increase in stressed environments. Even if a Covered Company's net derivatives funding position did not change, the use of gross derivative liability values in the add-on would require the Covered Company to raise more stable funding during the period of stress. As a result, the NSFR would be a pro-cyclical measure;
  - The proposed add-on does not recognize that back-to-back derivative transactions create offsetting obligations for posting and receiving variation margin and therefore present no contingent funding risk; and
  - The 20 percent used for the multiplier appears to be arbitrary.

We note that, as discussed in Part IV of this letter, other governmental bodies, such as the EC, have also expressed serious concerns about this 20 percent add-on, notwithstanding its inclusion in the Basel NSFR Framework.<sup>41</sup>

In addition, we reiterate our procedural concerns regarding the Agencies' failure to meaningfully disclose the analytical and empirical foundation regarding the treatment of derivatives pursuant to the proposed rule and thereby deprive the public of a meaningful opportunity to comment as required by the APA, as set forth in Part II.C above.

While the Associations are fundamentally opposed to the Agencies' adoption in any final rule of the 20 percent add-on for the reasons described above, we have nevertheless endeavored to provide a response—as best we can at the present time given the information we have—to the proposal's request to consider alternative methods for calculating the add-on. Based on our preliminary analysis, each of the alternatives set forth below has apparent advantages and disadvantages, and various issues would need to be addressed to finalize the add-on if calculated using one of these alternative methodologies:

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<sup>41</sup> European Commission, *DG FISMA Consultation Paper on Further Considerations For the Implementation of the NSFR In the EU*.



- **20 Percent Add-On As a Floor.** Under this alternative, a Covered Company would only recognize the 20 percent RSF charge to the extent that its net derivatives asset amount were less than the calculated add-on. If the Covered Company already recognized an RSF charge that would be equal to or greater than 20 percent of its gross liabilities, the Covered Company would not be subject to an additional RSF charge. An advantage of this approach is that it would resolve any concern the Agencies might have about a Covered Company not recognizing any RSF for derivatives based on its current positions, while not excessively and needlessly penalizing a Covered Company that already recognizes a material RSF charge for derivatives. In addition, this alternative would retain the basic structure of the Basel standard; however, it would not address some of the conceptual issues outlined above, primarily because it would be based on gross liabilities.
- **RSF Charge Applied to Net Asset/Liability Gap Amount.** Under this alternative, the add-on would take into account the value of variation margin, and apply a 20 percent RSF multiplier only to un-margined amounts, which would be accomplished by applying a 20 percent multiplier to the average balances of unsecured derivatives assets and unsecured derivatives liabilities. This alternative would have the advantage of retaining the basic structure of the Basel framework, but with limited technical modifications. This alternative, although not forward-looking or risk-sensitive, would solve the asymmetry issue created by the proposal applying only to derivatives liabilities. However, un-margined amounts may not be the best proxy for contingent funding obligations, particularly if they are un-margined because there is no requirement to post variation margin.
- **Historical Look-Back Approach.** A historical look-back approach would have the advantages of being risk-based, relatively simple, and grounded in empirical data. However, an inherent flaw in any historical look-back approach is that it is backward-looking and, to the extent a longer-than-necessary look-back period were selected, could restrict the ability of Covered Companies to actively manage their funding profiles and risks on a proactive basis. Any look-back approach should provide a mechanism to incentivize proactive risk management and reward remediation. This flaw could potentially be at least partly remedied if, in addition to selecting an appropriate period, the look-back excluded outlier positions from the historical population used to determine current funding risks and contained a framework to exclude historical portfolios that were no longer illustrative of current funding risks. While there are many ways to structure a historical look-back approach, one way might be to track the one-year maximum change in the value of a Covered Company's net unsecured derivative positions (unsecured asset amounts minus unsecured liability amounts) over a specified look-back period.
- **Modeled Estimates of Potential Future Exposure.** Using a measure of potential future exposure ("PFE") in either of its current forms—the Current Exposure Method

(“CEM”) or the Standardized Approach for Counterparty Credit Risk (“SA-CCR”)—would not be appropriate in the NSFR context unless it is carefully revised to address liquidity risk rather than credit risk. For instance, these measures do not recognize that margin inflows from one counterparty can fund margin outflows to another. The Associations are willing to explore further whether a modified version of CEM or SA-CCR would be suitable, but further analysis is required, particularly in light of the fact that international and U.S. regulators have not settled on a final PFE standard.<sup>42</sup> We believe an approach based on PFE would need very careful consideration and further analysis given its potential complexity.

- ***Recalibration of Multiplier.*** As noted above, the 20 percent multiplier appears to be an arbitrary number. If the Agencies’ goal is to apply a charge for future funding risk, a 5 percent charge on gross liabilities would be more appropriate in that it would parallel the 5 percent charge applied to off-balance sheet commitments, creating conceptual consistency within the NSFR framework.

We believe that the Agencies could adopt some combination of these alternatives and incorporate limited exemptions to address some of the conceptual flaws of the gross derivatives liability standard—including, for instance, exemptions for derivatives liabilities arising from (1) back-to-back offsetting transactions or (2) un-margined trades, neither of which present contingent funding risk.

We therefore urge the Agencies not to finalize the derivatives-related provisions of the proposed rule without first releasing the analytical underpinnings and empirical support for the 20 percent add-on and then, at a minimum, reopening the public comment period in order to give the public a meaningful opportunity to evaluate and comment upon this information. It is possible that a re-proposal of this element of the proposed rule may be warranted. In particular, the Agencies should: (i) address the fundamental conceptual concerns discussed above; (ii) set forth in detail the data that is purported to support the 20 percent add-on; (iii) perform the calculation using each of the alternatives identified above in order to evaluate each alternative against each of the others; and (iv) provide additional detail as to how each of the alternatives would operate in practice.

## **6. The U.S. NSFR should not be more stringent than the Basel NSFR Framework in respect of the 20 percent add-on by excluding settlement payments from the calculation.**

The proposed rule requires that Covered Companies should calculate the 20 percent add-on for derivatives liabilities gross of variation margin and settlement payments. We do not

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<sup>42</sup> In April 2016, the Basel Committee proposed to apply SA-CCR for the Basel Leverage Ratio, but its precise application in that context remains subject to change. The Agencies have not publicly indicated whether they will adopt SA-CCR in the United States.

believe this is appropriate and in particular, under any alternative for this calculation, the 20 percent add-on should not gross-up settlement payments.

Variation margin payments that are made under the “settled to market” or “STM” model fully extinguish a Covered Company’s obligation to its counterparty, and should not be treated equivalent to variation margin payments that constitute collateral. Even though variation margin payments made as collateral (under the “collateralized to market” or “CTM” model) or under the STM model are similar in that they mitigate an obligation or exposure and include counterparties exchanging periodic payments (typically daily), they differ in certain key aspects as regards their obligations to the counterparties.

- Under the CTM model, the exchange of variation margin does not legally reduce the amount of the derivative obligation but collateralizes the derivative obligation. The party that is “in the money” and has received variation margin collateral is obligated to return the collateral to its counterparty if the derivative value moves in the opposite direction.
- Under the STM model, the daily payments legally extinguish and settle any outstanding obligation of the counterparties. Neither party will be required to return any amount paid to settle a previous day’s obligation. The outstanding obligation or exposure is settled daily, and the terms of the derivative contract are reset so that the fair value of the contract is zero.

In addition, the proposed treatment of settlement payments in the NSFR would be at odds with the accounting treatment of settlement payments under U.S. GAAP, under which margin that is provided in the form of a settlement payment is accurately treated as reducing the Covered Company’s derivative liability amount, and also with the regulatory capital framework, which recognize the exposure-eliminating effects of the STM model in the calculation of the potential future exposure amount. Indeed, this aspect of the proposed rule would be unnecessarily more stringent than the Basel NSFR Framework—which does not require a gross-up for settlement payments—and would therefore put U.S. banking organizations at a material competitive disadvantage to their non-U.S. peers.

## **B. ASF Factor Framework**

### **1. Retail brokered deposits with a maturity of greater than one year should receive a 100 percent ASF factor.**

The proposal would require a 90 percent ASF factor for brokered deposits that mature one year or more from the calculation date with retail customers that are not reciprocal brokered deposits or brokered sweep deposits and are not held in a transactional account. For example, a brokered two-year term certificate of deposit with a retail customer would be assigned a 90 percent ASF factor under the proposed rule, while other liabilities with a maturity greater than one year receive a 100 percent ASF factor and deposits that are stable retail deposits held at a

Covered Company would receive a 95 percent ASF factor.<sup>43</sup> This is problematic given that: (i) the use of brokered deposits is unique to the United States as a significant funding source for depository institutions; (ii) the definition of what constitutes a “brokered deposit” under guidance issued by the FDIC in recent years potentially expands the universe of traditional funding arrangements that may be considered “brokered” deposits; and (iii) under the FDIC’s rules, only well-capitalized banking organizations can solicit and accept brokered deposits, which permit banking organizations to gain access to a larger pool of potential investment funds and thereby improve liquidity. Brokered deposits with longer-term maturities that are not held in transactional accounts are likely to be relatively stable and unlikely to pose the same policy concerns as brokered deposits more generally. We believe that the treatment of retail brokered deposits with a maturity greater than one year should mirror the treatment of other long-term liabilities that have a maturity of one year given the stable liquidity characteristics of these products in both stressed and unstressed environments and therefore that retail brokered deposits with a maturity greater than one year should receive a 100 percent ASF factor. This would also be consistent with the Basel Committee’s recent clarification in an FAQ that retail term deposits with a maturity over one year and that cannot be withdrawn without significant penalty receive a 100 percent ASF factor under the Basel NSFR Framework.<sup>44</sup>

Although the Agencies adopted a 10 percent outflow for such deposits for purposes of the LCR, finding that a Covered Company may “agree to waive such contractual maturity dates” during a stress period, this justification is inapplicable because the NSFR, as currently formulated, does not necessarily assume a period of idiosyncratic stress and the constraints during a crisis would not likely be operative during a one-year time horizon. Moreover, as several commenters noted during the LCR rulemaking, retail brokered deposits generally require that the retail customer must hold the brokered deposit to its stated maturity, subject to certain narrow exceptions, such as in the case of the death or adjudication of incompetence of the beneficial owner. Given the very limited nature of these exceptions, it is very unlikely that a retail brokered deposit would be accelerated prior to its stated maturity and therefore these instruments have virtually identical liquidity characteristics to any other liability with a maturity greater than one year.

Although some subset of retail brokered deposit agreements provide that retail customers may accelerate the maturity of the brokered deposit in other circumstances, by doing so the customer forfeits the interest payments on the deposit that have not been paid and the early redemption amount under the terms of the deposit agreement is likely to be significantly less than the principal amount (that is, an early withdrawal penalty is likely to be applied). From an

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<sup>43</sup> A stable retail deposit is defined under the LCR rule as a retail deposit that is entirely covered by deposit insurance and (i) is held by the depositor in a transactional account; or (ii) the depositor that holds the account has another established relationship with the banking organization such as another deposit account, a loan, bill payment services, or any similar service or product provided by the depositor that the banking organization demonstrates would make deposit withdrawal highly unlikely during a liquidity stress event.

<sup>44</sup> See Basel Committee, *Basel III – The Net Stable Funding Ratio: frequently asked questions*, p. 5 (July 2016).

empirical perspective, retail customers accelerate the maturity of brokered deposits very infrequently due to the loss of these interest payments and imposition of such penalty.

Moreover, the disparate treatment of brokered deposits and other liabilities with a maturity greater than one year is particularly unwarranted in light of the relatively expansive definition of “brokered deposit” discussed in the guidance published by the FDIC pursuant to the FDI Act.<sup>45</sup> The potentially broad sweep of the brokered deposit definition discussed in this most recent and prior FDIC guidance is largely intended to address historical concerns with the “improper management” and “overuse” of brokered deposits to fund “unsound or rapid expansion of loan and investment portfolios,” rather than present concerns with the long-term liquidity risk of a particular banking organization.<sup>46</sup> Indeed, the FDIC recognized in its recent guidance that brokered deposits “can be a suitable funding source when properly managed as part of an overall, prudent funding strategy.”<sup>47</sup>

Given that brokered deposits are already subject to regulation by the FDIC and effectively penalized under a number of other post-crisis Agency reforms,<sup>48</sup> we believe that retail brokered deposits with a maturity greater than one year should be assigned a 100 percent ASF factor in recognition of their stable funding characteristics, which are similar to that of other liabilities with a maturity greater than one year.

**2. Brokered transaction deposits should receive a 90 percent ASF factor because these deposits are nearly identical in practice to retail deposits.**

Under the proposed rule, a brokered deposit with a retail customer or counterparty that is held in a transactional account with a maturity of greater than six months would receive a 50 percent ASF factor. Due to the recent potential expansion of the types of deposits that may qualify as brokered deposits under the FDIC’s guidance, many stable transactional account products that act as stable retail funding could be classified as “brokered” due to a referral from a third party. In contrast, despite the demonstrated stability of these products, certain other brokered deposits provided by a retail customer or counterparty would receive a 90 percent ASF factor: (i) a reciprocal brokered deposit where the entire amount is covered by deposit insurance; (ii) a brokered sweep deposit deposited in accordance with a contract between the retail customer or counterparty and the banking organization, a controlled subsidiary of the banking organization or a company that is a controlled subsidiary of the same top-tier company of which the banking organization is a controlled subsidiary, where the entire amount of the deposit is covered by

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<sup>45</sup> See FDIC, *Identifying, Accepting, and Reporting Brokered Deposits Frequently Asked Questions* (updated June 30, 2016).

<sup>46</sup> FDIC, *Identifying, Accepting, and Reporting Brokered Deposits Frequently Asked Questions* (updated June 30, 2016).

<sup>47</sup> *Id.*

<sup>48</sup> See, e.g., 12 C.F.R. § 217.406.

deposit insurance; or (iii) a brokered deposit that is not held in a transactional account and that matures one year or more from the calculation date. The proposal's treatment of brokered transactional account deposits is also more punitive than the LCR's 20 percent outflow rate for such deposits. Given that the LCR is a stressed metric, the misalignment with the NSFR is even more striking.

Accordingly, we believe that a brokered deposit with a retail customer held in a transactional account should receive a 90 percent ASF factor given that these brokered deposits function substantially similarly to retail deposits from an empirical perspective. As indicated above, the FDIC has expanded the types of funding arrangements that constitute brokered deposits, such that deposits held in a transactional account may be subject to this treatment even if such deposits provide nearly identical stable funding to retail deposits.

**3. Brokered sweep deposits received from unaffiliated institutions should receive a 90 percent ASF factor, in line with brokered sweep deposits received from affiliates, to the extent that the Covered Company has priority that is comparable to the priority of an affiliate brokered sweep deposit.**

The proposed rule provides that a brokered sweep deposit that is deposited in accordance with a contract between the retail customer or counterparty that provides the deposit and the Covered Company or an affiliate of the Covered Company is assigned a 90 percent ASF factor where the entire amount of the deposit is covered by deposit insurance. This treatment is in contrast to a brokered sweep deposit in which there is no affiliate relationship, which would receive a 50 percent ASF factor under the proposed rule.

The Agencies' stated rationale for assigning a lower ASF factor to unaffiliated brokered deposits is that affiliates are more likely to receive and maintain a supply of brokered sweep deposits because affiliates "tend to be the first to receive deposits and the last from which deposits are withdrawn," and thereby receive a more favorable position and enhanced funding stability characteristics under the priority waterfall by virtue of the affiliate relationship.<sup>49</sup> We believe that this rationale should logically be applied to unaffiliated brokered sweep deposits that receive a similar priority waterfall position to affiliate brokered sweep deposits. These brokered sweep deposits would exhibit substantially similar funding characteristics and thus should also receive 90 percent ASF factor treatment, even absent an affiliate relationship.

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<sup>49</sup> See NSFR Proposed Rules, at 35,137.

**4. The Agencies should assign a 50 percent ASF factor to non-maturity brokered deposits that are held in a savings account, given that these deposits are substantially similar to deposits in a retail savings account from a stability perspective.**

We believe that the proposed rule's ASF treatment for non-maturity brokered deposits that are held in traditional savings accounts greatly overstates the funding risk associated with such accounts. Specifically, the proposed rule would apply: (i) a 0 percent ASF factor to a brokered deposit that is not held in a transactional account and that matures in less than six months; and (ii) a 50 percent ASF factor to a brokered deposit that is not held in a transactional account and that matures in one year or more. Because brokered savings accounts are non-maturity deposits they would receive no ASF value under the proposed rule despite being nearly identical to brokered transactional accounts, which receive an ASF factor of 50 percent. Because brokered savings accounts share many important characteristics with a direct retail savings account, in that accountholders generally benefit from FDIC insurance and can avail themselves of direct deposit and other services, in addition to potentially holding other accounts with the same banking organization, we believe that application of a 50 ASF factor is appropriate. Indeed, many of these accounts are offered as a complement to the customer's transactional account and therefore serve the same customer service function as the transactional account. Likewise, the sole difference between brokered savings accounts and "direct" retail savings accounts is the manner in which the account is introduced to the banking organization due to the broad application of the definition of "deposit broker." Accordingly, we respectfully request that the Agencies assign these deposits a 50 percent ASF factor in any final NSFR rule.<sup>50</sup>

**5. The Agencies should not compound the already punitive treatment of operational deposits under the LCR rule by applying a 50 percent ASF haircut to operational deposits, and should instead assign a higher ASF factor to such deposits to align more closely with their treatment under the LCR rule.**

With respect to operational deposits placed with an applicable Covered Company, the proposed rule would generally apply the definition of operational deposits under the LCR rule. The LCR rule imposes stringent operational criteria that must be satisfied to recognize a deposit as an operational deposit, including that the banking organization demonstrates that the deposit is empirically linked to the operational services it provides and that the banking organization has a methodology that takes into account the volatility of the average balance in order to identify any excess amount, which must be excluded from the operational deposit amount. As a supervisory

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<sup>50</sup> These types of deposits are also not explicitly addressed in the LCR. We believe that these deposits should receive an outflow rate of 20 percent for fully insured balances and an outflow rate of 40 percent for partially insured balances under the LCR. Given that these deposits are often offered as a complement to transaction accounts, we believe that they should be afforded similar treatment. We note that this proposed treatment, both under the NSFR and the LCR, would not apply to other time deposits, such as maturing certificates of deposit.

matter, the Agencies also require Covered Companies to employ robust review processes to identify excess amounts of deposits based on granular historical deposit data. In addition, and as part of the Agencies' more stringent implementation of the LCR rule in comparison to the Basel framework, the operational deposit must not be provided in connection with the provision of operational services to a non-regulated fund, including services provided to a non-regulated fund, as these deposits are excluded from the U.S. operational deposit framework. The Clearing House and other trade associations previously expressed concerns with respect to the highly conservative treatment of operational deposits under the LCR rule in a letter to the Agencies on the proposed LCR Rule.<sup>51</sup>

Further compounding these issues, the proposed rule would apply a 50 percent ASF factor to operational deposits. In contrast, the LCR rule assigns a 25 percent outflow rate for operational deposits that are not held in escrow accounts. This more punitive treatment in the NSFR framework—essentially a doubling of the applicable haircut for operational deposits in comparison to the LCR rule—is unwarranted. While the outflow amounts in the LCR rule are calibrated based on a 30-day scenario of severe stress, the proposal specifies that the NSFR is not intended to reflect funding needs over a long-term stressed period. In light of this conceptual departure from the LCR rule, we do not believe that there is any analytical rationale for doubling the haircut for operational deposits under the proposed rule from that applicable under the LCR rule. Indeed, we posit that this treatment is far too conservative for a structural measure of liquidity such as the NSFR.<sup>52</sup>

The Preamble indicates that the more conservative treatment of operational deposits in the proposed rule is closer to that of non-operational deposits because the Agencies believe it is more reasonable to assume that the counterparty can restructure its operational deposits over the NSFR's longer one-year time horizon and may elect to place these deposits with another financial institution during that period than would be the case under the LCR rule's 30-day

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<sup>51</sup> See Letter from The Clearing House Association L.L.C., the American Bankers Association, the Securities Industry and Financial Markets Association, the Financial Services Roundtable, the Institute of International Bankers, the International Association of Credit Portfolio Managers and the Structured Finance Industry Group to the Agencies re: Liquidity Coverage Ratio: Liquidity Risk Management, Standards, and Monitoring, pp. 11-18 (Jan. 31, 2014).

<sup>52</sup> In addition, we do not believe there is a compelling policy reason why the Agencies should pre-emptively disqualify deposits that result from the provision of operational services to a non-regulated fund from categorization as an operational deposit, provided that all other qualification requirements in the LCR rule are met. There is strong empirical evidence that operational deposits are a highly stable source of funding, whether assessed over a 30-day period of severe stress or over a one-year unstressed environment, regardless of the underlying client type, and therefore no reason for the exclusion of deposits from non-regulated funds and the imposition of a more severe ASF factor to such deposits in the Proposed Rule. We also urge the Agencies to eliminate the unwarranted exclusion of operational deposits that result from the provision of operational services to a non-regulated fund in the LCR rule.



scenario.<sup>53</sup> However, we believe that this rationale for the disparate treatment of operational deposits is incorrect for two primary reasons.

First, as an empirical matter, operational deposits have been shown to be a stable source of funding for banking organizations that provide operational services to their clients, and it is unlikely that a substantial number of counterparties would seek to restructure their respective operational deposits and place them with another financial institution in an environment intended to reflect “all market conditions” over a one-year time period.

Second, application of a 50 percent ASF factor for operational deposits produces outcomes which are inconsistent with—and in certain cases substantially more stringent than—the results of cash flow projections derived by banking organizations as part of the required stress testing of their liquidity risk, including in the Federal Reserve’s annual CLAR process. We believe it is therefore inappropriate to assign an ASF factor to operational deposits in the NSFR that is calibrated on the basis of a period of financial market stress. Because the NSFR is intended to reflect all market conditions—both stressed and unstressed—we encourage the Agencies to be informed by the results of liquidity stress testing when assessing the appropriate treatment of operational deposits in the NSFR framework, particularly in light of the emphasis the Agencies have placed on empirical analysis of the appropriate treatment of operational deposits in the LCR and the proposed rule.

In light of the foregoing, a higher ASF factor would better reflect the behavior of these deposits over a one-year time horizon intended to reflect all market conditions and would also align the treatment of operational deposits under the NSFR with the LCR rule.

- 6. Non-deposit liabilities owed to a retail customer or counterparty with a remaining maturity of six months or less should be assigned a 50 percent ASF factor or, in the alternative, unsecured liabilities of a broker-dealer subsidiary of a Covered Company should be assigned a 50 percent ASF factor when such liabilities are owed to a retail customer or counterparty and arise in connection with a transactional account at the broker-dealer.**

The proposed rule would apply a 0 percent ASF factor to any NSFR liability with less than six months of remaining maturity that is owed to a retail customer or counterparty that is not a deposit and is not a security issued by the banking organization.<sup>54</sup> We believe that the proposed rule should apply a 50 percent ASF factor to non-deposit liabilities owed to a retail customer or counterparty with a remaining maturity of less than six months, or, in the alternative, apply a 50 percent ASF factor to unsecured liabilities of a broker-dealer subsidiary of a U.S. banking organization when such liabilities are: owed to a retail customer or counterparty and

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<sup>53</sup> See NSFR Proposed Rules, at 35,138.

<sup>54</sup> NSFR Proposed Rules § 104(e)(3).

arise in connection with a transactional account at such broker-dealer. The proposed rule's failure to recognize the available stable funding provided by these liabilities is inappropriate.

First, this treatment is in direct conflict with assumptions under the LCR rule and the G-SIB Surcharge with respect to retail customer behavior. The LCR rule applies a 40 percent outflow to non-deposit funding received from retail customers, as opposed to the 100 percent outflow that applies to unsecured wholesale funding received from financial sector entities.<sup>55</sup> The Agencies specifically revised the outflow assumptions for non-deposit retail funding during the U.S. LCR rulemaking process from 100 percent to 40 percent, observing that a 40 percent outflow rate “better reflect[s] the liquidity risks of categories of unsecured retail funding that have liquidity characteristics that more closely align with” retail customer brokered deposit funding.<sup>56</sup>

Similarly, the G-SIB Surcharge excludes non-deposit retail customer funding entirely from its Method 2 calculation methodology, thereby implicitly suggesting that such funding is indeed stable. The Federal Reserve explained this approach in the G-SIB Surcharge final rule by noting that, “[a]s evidenced in the financial crisis, funding from wholesale counterparties presents greater run risk to banking organizations during periods of stress as compared to the same type of funding provided by retail counterparties, because wholesale counterparties facing financial distress are likely to withdraw large amounts of wholesale funding in order to meet financial obligations.”<sup>57</sup>

Second, insofar as liabilities owed to retail customers arise in connection with a transactional account at a broker-dealer, they pose comparable counterparty credit risk with respect to the customer as uninsured deposits. In fact, brokerage accounts are commonly structured to give retail customers the option of either sweeping excess brokerage account balances into an affiliated banking organization subsidiary as deposits or maintaining them at the broker-dealer entity as receivables. Under the sweep structure, the amounts swept to the affiliated banking organization subsidiary receive 50 percent ASF recognition in the proposed rule when they are in excess of deposit insurance limits.<sup>58</sup> In the absence of deposit insurance protection, clients may decide to leave these balances with the broker-dealer entity, since it is generally comparable from a credit risk perspective to sweeping them into a bank account.<sup>59</sup> Even when individual retail customers choose not to leave excess cash positions at the broker-dealer entity for long periods, broker-dealers will generally have stable aggregate balances of

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<sup>55</sup> LCR rule § 32(a)(5) (40% outflow for non-deposit retail customer or counterparty funding); § 32(h)(5) (100% outflow for unsecured wholesale funding from financial sector entities).

<sup>56</sup> 79 Fed. Reg. 61,440, 61,481 (Oct. 10, 2014).

<sup>57</sup> 80 Fed. Reg. 49,082, 49,098 (Aug. 14, 2015).

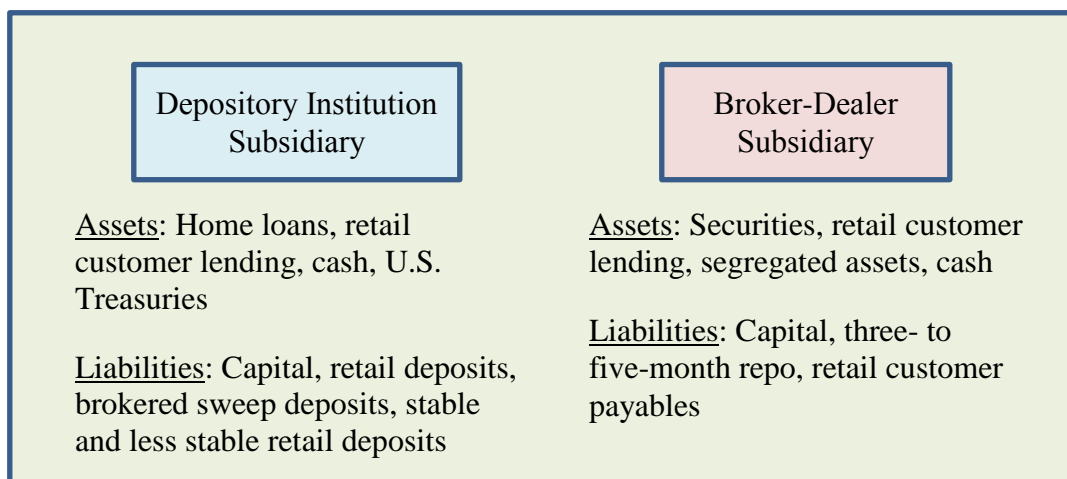
<sup>58</sup> NSFR Proposed Rules § 104(c)(7) (partially insured brokered sweep deposits).

<sup>59</sup> Some retail customer brokerage account structures also provide customers with the option of investing excess amounts in mutual funds or other assets that eliminate the broker-dealer's payables.

payables across all retail customer relationships, as overall customer activity remains relatively constant and day-to-day customer transaction activity requires or results in such payables. Because the retail customer account balances have a comparable level of counterparty credit risk as uninsured deposits, they should be afforded similar ASF recognition under the proposed rule.

Third, by assigning a 0 percent ASF factor as proposed, the Agencies will unnecessarily penalize business models that focus on retail customer sales and trading, even though these business models have not proved empirically to be sources of greater systemic risk. Consider the following illustrative business model:

### Illustrative Retail Customer-Focused BHC Business Model



This relatively simple business model would face significant constraints under the proposed rule. While the depository institution subsidiary may have excess ASF, given its deposit funding base, the retail-focused broker-dealer entity would be able to rely only on its capital as a source of ASF where three- to five-month repurchase agreement funding and retail customer payables would each receive 0 percent ASF recognition. If the depository institution and broker-dealer subsidiaries were of approximately equal size, the consolidated BHC would face ASF shortfall challenges, as the excess ASF of the depository institution subsidiary would be unavailable to support the firm's nonbank RSF requirements.<sup>60</sup> We do not believe this disparate treatment is analytically justified.

Fourth, assigning a 0 percent ASF factor to retail customer-facing liabilities is generally inconsistent with the observed funding stability of these positions by many banking organizations, including in stressed market conditions.

<sup>60</sup> NSFR Proposed Rules § 108.

For these reasons, the Agencies should recognize the ASF benefit of these funding sources by applying a more appropriate 50 percent ASF factor for liabilities owed to a retail customer or counterparty. To the extent that the Agencies choose to limit such recognition to the particularly compelling example of retail customer payables at broker-dealer entities, our recommendation to assign a 50 percent ASF factor to liabilities owed to a retail customer in connection with a transactional account at a broker-dealer provides a clear and narrowly defined methodology, which utilizes the same “transactional account” qualifier adopted by the agencies in the LCR rule for purposes of calibrating retail customer deposit account outflow assumptions.<sup>61</sup>

### C. RSF Factor Framework

- 1. In calibrating RSF factors, the proposed rule incorrectly applies parameters from the LCR rule, a short-term stressed metric, which results in RSF factors that do not accurately reflect the amount of required amount of stable funding for a Covered Company across all market conditions over a one-year time horizon.**

The proposed RSF factors rely heavily on parameters imported from the LCR rule, which is inconsistent with the concept of the NSFR as a structural measure of funding intended to reflect “all market conditions.” As a result, some assumptions underlying the design and calibration of the LCR rule are no longer appropriate to apply in the NSFR context, as a number of high-quality assets represent stable sources of structural liquidity over the one-year time horizon under all market conditions provided in the NSFR and therefore should be afforded more beneficial RSF factor treatment. While “all market conditions” can include periods of stress, they also, by definition, include normal operating environments. Thus, this more favorable treatment under the NSFR is inherently justified because the LCR is by design an exclusively stressed metric.

For example, because the LCR rule excludes obligations of a financial sector entity and obligations of a consolidated subsidiary of a financial sector entity from treatment as Level 2A and Level 2B HQLA, publicly traded equity securities and investment grade debt securities that are not included as HQLA would receive an 85 percent RSF factor. Although we recognize that the Agencies elected not to treat these financial sector securities as liquid assets in the context of the 30-day LCR stress scenario, we do not believe that there is an empirical basis for this treatment of financial sector equity or investment grade debt securities under the proposed rule, which would require Covered Companies to hold significantly more stable funding for these securities in contrast to non-financial companies. Moreover, this 85 percent RSF factor is far greater than the haircuts that would otherwise apply in the secured funding market in the experience of many banking organizations and is likely to add significant costs for those

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<sup>61</sup> LCR rule § 3 (definition of “stable retail deposit”); § 32(g)(3)-(4) (outflow assumptions for retail customer brokered deposits).

organizations that provide critical market-making and related services in these markets and would restrict the flow of capital to financial sector entities without appropriate justification. This issue is further compounded by the broad definition of “financial sector entity” in the LCR rule, which includes, among other entities, insurance companies and mutual funds, such that securities issued by these entities would also be assigned an 85 percent RSF factor. We believe that in the context of the NSFR, publicly traded and investment grade obligations of a financial sector entity or a consolidated subsidiary of a financial sector entity should therefore receive a lower RSF factor.

Similarly, in line with the treatment under the LCR rule, non-financial institution equity securities that are publicly traded and meet certain liquidity requirements and investment grade corporate bonds are assigned a 50 percent RSF factor as Level 2B HQLA. While the Agencies note that investment grade corporate bonds have higher credit risk and lower average daily trading volume relative to Level 1 and Level 2A HQLA, we believe that this rationale is less compelling—and the resultant RSF factor is less appropriate—when one considers these securities in the context of a structural metric over a one-year time horizon intended to reflect all market conditions. Banking organizations perform a vital market-making function by purchasing and selling inventories of equities and other securities, which supports and finances the real economy. Publicly traded equities that meet certain liquidity requirements and investment grade corporate bonds should be assigned a lower RSF factor in light of the liquidity characteristics of these assets over a one-year time horizon intended to reflect all market conditions.

In addition, non-residential asset-backed securities (“ABS”) and commercial MBS (“CMBS”) assets are assigned an 85 percent RSF factor under the proposed rule, based on a series of stringent assumptions regarding the ability to monetize these assets in a stressed environment originating from the LCR rule. In the NSFR context it would be more appropriate for structured investment vehicles backed by financial assets, such as non-residential ABS and CMBS, to receive relatively more favorable RSF treatment in light of the fact that these assets typically benefit from stable and predictable cash flows, have robust secondary market liquidity and are fully secured by the underlying loan receivables. Moreover, in contrast to investment grade corporate bonds (which would receive a 50 percent RSF factor as Level 2B HQLA), ABS and CMBS benefit from credit enhancements that mitigate credit risk, including through the use of “tranches” in which a subordinated class of securities assumes the first lost position in the event of default on the underlying loan receivables and more senior securities absorb any losses thereafter. ABS and CMBS also generally maintain additional credit protections such as reserve accounts and the collection of interest payments beyond what is immediately due to bond holders that further insulate the holders of the senior tranches from losses.

Similarly, Agency MBS would receive a 15 percent RSF factor as Level 2A HQLA under the proposed rule. We believe that Agency MBS should be treated as Level 1 HQLA and assigned a 5 percent RSF factor for purposes of the NSFR, at least as long as Fannie Mae and Freddie Mac remain in conservatorship and receive funding commitments from the U.S. Department of the Treasury. A key feature of U.S. Agency MBS is their substantial liquidity as

market participants perceive that they are typically able to buy and sell significant quantities of Agency MBS without difficulty and face relatively low transaction costs. Accordingly, many Agency MBS investors hold these securities as a liquid investment that they expect can be quickly converted to cash at low cost when the need arises while earning a positive rate of return.<sup>62</sup> Thus, Agency MBS should be afforded more favorable treatment than their non-U.S. equivalents under the Basel NSFR Framework and should be assigned a lower RSF factor, especially in the context of a longer-term, broader market conditions metric like the NSFR.

We also note that, with respect to the implementation of the LCR in the European Union (“EU”), covered bonds with a certain credit quality may be treated as Level 1 HQLA under the LCR.<sup>63</sup> Covered bonds are similar to Agency MBS in the United States — debt instruments that are secured by a pool of assets consisting of mortgage loans or public sector debt to which investors have a preferential claim in the event of default. Similar to covered bonds, Agency MBS have exhibited favorable liquidity characteristics and are low-risk assets even in stressed conditions. We urge the Agencies to similarly recognize the unique aspects of U.S. Agency MBS, at least for purposes of the NSFR.

## **2. Subjecting repurchase agreements to asymmetric treatment under the proposed rule would unduly restrict an important funding market for BHCs.**

Repurchase and reverse repurchase transactions would be subject to asymmetric treatment under the proposed rule in that short-term funding from financial sector entities received by a Covered Company is assigned a 0 percent ASF, whereas short-term lending to financial sector entities by a Covered Company is assigned a 10 percent or 15 percent RSF factor, depending on the quality of the assets underlying the repurchase transaction and whether the Covered Company has rights of rehypothecation with respect to the underlying assets. Thus, the proposed rule would require a Covered Company to hold stable funding against a repo book that is perfectly matched, effectively imposing yet another tax on these transactions, even though the repo market for U.S. Treasuries and related assets should be considered stable under the structural construct of the NSFR.<sup>64</sup> Repo transactions play a vital role within the financial system and underpin the functioning of the capital markets, including the market for U.S. Treasury securities, collateral management and money markets. More generally, the Associations are concerned that the functioning of these markets may be negatively impaired by

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<sup>62</sup> See Federal Reserve, *FEDS Notes, Measuring Agency MBS Market Liquidity with Transaction Data* (Jan. 31, 2014), available at: <https://www.federalreserve.gov/econresdata/notes/feds-notes/2014/measuring-agency-mbs-market-liquidity-with-transaction-data-20140131.html>.

<sup>63</sup> See Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions.

<sup>64</sup> We recognize that the proposed rule permits netting for secured lending and secured funding transactions with the same counterparty if certain netting criteria under the SLR are satisfied, but this is not sufficient because this applies only with respect to repurchase transactions with the same counterparty.

the assignment of a 10 percent or 15 percent RSF factor on short-term lending to financial sector entities, given that these types of short-term transactions comprise the vast majority of all interbank and inter broker-dealer lending.<sup>65</sup>

Recent regulatory enactments have already increased the cost of maintaining a matched repo book, in particular the SLR and the G-SIB Surcharge. The SLR does not take into account the riskiness of the banking organization's assets, such that a banking organization that funds its repos with relatively low-risk assets such as U.S. Treasuries must nonetheless hold significant amounts of capital against these repos. In addition, the G-SIB Surcharge calculation methodology as implemented in the United States (specifically, Method 2) measures reliance on short-term wholesale funding—an element unique to the U.S. G-SIB Surcharge and one that is not included in the Basel Committee's framework—such that a banking organization that engages in a large number of matched-book repos will have a higher G-SIB Surcharge. As a result, matched repo books are already subject to higher capital requirements in the United States. There is increasing evidence that these regulatory enactments have led to a reduction in intermediation in financial markets by Covered Companies and an attendant deterioration in market liquidity and price transparency and increase in market volatility.<sup>66</sup> We are concerned that the treatment of matched repo books in the proposed rule would further exacerbate these conditions, especially because repurchase transactions are generally a high volume and low margin business for many banking organizations.

In addition, the effects of the NSFR on banking activities more broadly has been the subject of focus by international regulators, with a particular emphasis on repos and other short-term transactions with financial institutions. The EC has requested evidence regarding possible issues raised by the asymmetric treatment of short-term transactions with financial institutions and possible alternatives and has stated that “too punitive treatment” of short-term repo transactions may limit access to funding sources by banking organizations and increase constraints on the ability of banking organizations to provide necessary financing to the EU economy.<sup>67</sup>

We share the concerns of the EC (discussed in Part IV below) as it relates to the treatment of short-term repo transactions under the proposed rule and urge the Agencies to, if it is deemed necessary, consider other avenues to address these repo transactions in a manner that would not unduly constrain important funding markets. We understand that the intention of this asymmetric treatment was to impose a cost on matched repo portfolios because the LCR rule does not require banks to hold HQLA against a matched repo portfolio, irrespective of its size. However, we believe that a more targeted approach may achieve this regulatory objective

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<sup>65</sup> The Clearing House, *The Net Stable Funding Ratio: Neither Necessary nor Harmless* (July 2016), available at: [https://www.theclearinghouse.org/~media/tch/documents/20160705\\_tch\\_nsfr\\_note.pdf](https://www.theclearinghouse.org/~/media/tch/documents/20160705_tch_nsfr_note.pdf).

<sup>66</sup> *Id.*

<sup>67</sup> European Commission, *DG FISMA Consultation Paper on Further Considerations for the Implementation of the NSFR in the EU*, p. 1.

without imposing unnecessary and significant costs on the funding activities of Covered Companies and on the economy more broadly. We strongly encourage the Agencies to work with their European counterparts and the Associations to develop a more targeted and efficient treatment of repos and reverse repos for these purposes.

**3. The proposed rule contains conceptual inconsistencies, both internal and contrasted with the LCR, that should be eliminated.**

The proposed rule appears to contain a number of internal inconsistencies. First, the proposed rule would assign a 0 percent RSF factor for assets such as currency and coin, Reserve Bank balances and claims on a foreign central bank with a maturity of less than six months, while it would assign a 5 percent RSF factor for Level 1 HQLA such as U.S. Treasuries. There is no explanation in the proposed rule of the conceptual basis that the Agencies relied upon in proposing this differential treatment. We believe it is both illogical and inconsistent with the liquidity characteristics of these instruments to subject Level 1 HQLA to a 5 percent haircut relative to the assets that are assigned a 0 percent RSF factor when these assets have substantially similar liquidity and credit risk characteristics over the NSFR's time horizon. We therefore respectfully request that these assets be assigned the same RSF factor in order to provide an accurate picture of a Covered Company's liquidity position and to avoid undue distortions.

Similarly, the LCR applies a 0 percent haircut to U.S. Treasuries, meaning that the LCR rule assumes that 100 percent of U.S. Treasuries can be monetized by a Covered Company over a 30-day stress scenario. In contrast, by virtue of assigning a 5 percent RSF factor, the NSFR effectively assumes that only 95 percent of U.S. Treasuries can be monetized (via outright sale or a repurchase transaction) over a one-year time horizon, representing an unduly conservative and logically inconsistent departure from the LCR.<sup>68</sup> As such, Treasuries should receive a 0 percent RSF factor.

**4. The proposed rule should recognize the availability of FHLB advances in stressed and unstressed environments by reducing the RSF factors that are applicable to assets that are eligible for FHLB advances or, in the alternative, assigning an ASF factor greater than 0 percent to the unused borrowing capacity from FHLBs.**

The proposed rule does not appropriately take into account the availability of FHLB advances either in assigning RSF factors for assets that are eligible for FHLB advances or in providing a non-zero ASF factor for unused FHLB borrowing capacity. In recognition of the liquidity benefits that banking organizations derive from FHLB advances, which have been shown empirically to be a stable source of funding in stressed and unstressed environments, we believe that the Agencies should lower the RSF factors that would be applicable to RSF assets

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<sup>68</sup> The Clearing House, *The Net Stable Funding Ratio: Neither Necessary nor Harmless* (July 2016), available at: [https://www.theclearinghouse.org/~media/tch/documents/20160705\\_tch\\_nsfr\\_note.pdf](https://www.theclearinghouse.org/~media/tch/documents/20160705_tch_nsfr_note.pdf).



that are eligible for FHLB advances or, in the alternative, assign an ASF factor greater than zero with respect to Covered Companies' unused borrowing capacity from FHLBs.

The FHLBs provide “advances” to banking organizations in the form of loans to member institutions either on an overnight or a term basis and collateralized by certain eligible mortgages and other assets that support the financing of residential mortgages. The FHLBs thus provide liquidity to member institutions that in turn facilitate the flow of credit and services to facilitate housing and community development. These FHLB advances represent a funding source unique to the United States that should be available to banking organizations in both stressed and unstressed environments. Indeed, FHLB advances proved empirically to be a stable source of funding throughout the financial crisis, even at institutions that failed or were acquired under distress,<sup>69</sup> and independent analysis conducted by The Clearing House shows that the FHLBs continued to provide liquidity that banks could draw upon during the financial crisis, increasing its lending to members in every part of the country by more than 50 percent—or \$300 billion—between the second quarter of 2007 and the third quarter of 2008.<sup>70</sup>

Although the Agencies chose not to recognize FHLB capacity either by including the unused amount of assets pledged to the FHLB in the definition of HQLA or as a potential inflow in the denominator in the LCR, we believe that it is not appropriate to extend this treatment in the NSFR context. The NSFR, unlike the LCR, is a structural metric intended to reflect the stable funding required across all market conditions over a longer one-year time horizon. The Associations therefore urge the Agencies to recognize the empirical soundness and stability of this funding source that is unique to the U.S. financial system by lowering the RSF amount for assets that are eligible for FHLB advances in recognition of the fact that these assets are eligible for FHLB advances to the extent that a banking organization has excess borrowing capacity at the FHLBs, such as eligible residential mortgages, U.S. government and agency securities and state and municipal securities.

We recognize that FHLB advances are a source of liquidity for banking organizations only to the extent that the banking organization has unused borrowing capacity at the FHLBs. In the interests of simplicity, we would therefore recommend a conservative decrease in the RSF factor for eligible assets that is less than the empirically demonstrable full liquidity benefits of FHLB advances, in recognition of the fact that the amount of unused borrowing capacity of a banking organization may fluctuate over time and to limit the complexity of recognition of FHLBs as a source of liquidity.

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<sup>69</sup> See The Clearing House, *Assessing the Basel III Net Stable Funding Ratio in the Context of Recent Improvements in Longer-Term Bank Liquidity* (Aug. 2013), available at: <https://www.theclearinghouse.org/~media/files/association%20documents/20130829%20tch%20study%20assessing%20the%20basel%20iii%20net%20stable%20funding%20ratio%20in%20the%20context%20of%20recent%20improvements%20in%20bank%20liquidity.pdf>.

<sup>70</sup> The Clearing House, *The Basel III Liquidity Framework: Impacts and Recommendations* (Nov. 2011), available at: <https://www.theclearinghouse.org/~media/files/association%20documents/20111102%20tch%20study%20of%20basel%20iii%20liquidity%20framework.pdf>.

In the alternative, the Agencies should assign a nonzero ASF factor with respect to the unused borrowing capacity that a Covered Company has at the FHLBs. As noted above, FHLB advances are an important and unique source of liquidity for U.S. banking organizations that have been shown to be available empirically in both stressed and unstressed conditions. This important source of liquidity should be recognized by assigning a nonzero ASF factor to the extent of a Covered Company's unused borrowing capacity given the availability of this funding source for eligible banking organizations.

**5. Trade date receivables that fail to settle within the standard settlement period but that are expected to settle should be assigned a 0 percent RSF factor, in line with the treatment provided in the Basel NSFR Framework.**

The proposed rule would assign a 100 percent RSF factor to trade date receivables that fail to settle within the standard settlement period (as an asset not otherwise assigned an RSF factor). However, under the Basel NSFR Framework trade date receivables that have failed but are still expected to settle are assigned a 0 percent RSF factor. Because the Covered Company still expects to receive trade date receivables when these transactions are expected to settle, stable funding should not be required for these assets and they should therefore continue to receive a 0 percent RSF factor rather than the 100 percent RSF factor that would be assigned by default under the proposed rule.

Moreover, standard market settlement periods vary significantly by transaction type. For example, the standard settlement period for certain loan products can be as high as 30 days. In light of this variation, the Agencies should not apply the lesser of five days and the market standard settlement period in determining whether to assign a 0 percent RSF factor because the standard settlement period for certain instruments may be longer than five days. Rather, we believe the Agencies should amend the rule to provide that the RSF factor assigned to trade date receivables that are expected to settle should be based upon settlement within the *greater of* (i) the standard market settlement period and (ii) five days.

**6. Segregated client assets should not be assigned an RSF factor greater than zero because Covered Companies do not have long-term funding obligations with respect to client assets that are held in a segregated account.**

The proposed rule would require a Covered Company to apply an RSF factor to a client asset held in a segregated account based on the RSF factor that would be assigned to the client asset on a standalone basis if it were not held in a segregated account. The Preamble notes that the proposed rule would treat cash that a Covered Company places on deposit with a third-party insured depository institution as a short-term loan to a financial sector entity receiving a 15 percent RSF factor, and U.S. Treasury securities held by the Covered Company in a segregated account pursuant to an applicable customer protection regime would be assigned a 5 percent RSF factor. These RSF factors do not reflect the actual funding required for segregated assets that

represent property held for the benefit of clients even though they are reflected on the Covered Company's accounting balance sheet. The disparate treatment of cash and U.S. Treasury securities in segregated client accounts also illogically incentivizes Covered Companies to hold segregated client assets in non-cash form, even though cash would clearly pose the lowest liquidity and funding risk.

It is very common for broker-dealer and future commission merchant subsidiaries of Covered Companies to maintain segregated client assets on their balance sheets. As has been noted in other contexts, including the SLR, assets held in segregated accounts governed by market regulators' reinvestment standards are necessary to permit clients to invest and transact in trading markets.<sup>71</sup> These assets are held for the benefit of clients and directly correspond to client-facing liabilities. To the extent that clients seek to reduce their investment or trading and withdraw funds, the Covered Company returns the segregated assets to its clients. As such, the assets are directly funded by clients and do not require long-term funding support from the Covered Company.

Because Covered Companies do not have long-term funding obligations with respect to segregated asset amounts, segregated client assets that are on the balance sheet of a Covered Company should be treated analogously to "currency and coin" of the bank, which would receive a 0 percent RSF under the proposed rule,<sup>72</sup> in accordance with the Basel NSFR Framework for monies immediately available to meet obligations.<sup>73</sup> Similar to currency and coin, segregated client assets are limited to cash and cash-like instruments that meet regulatory liquidity standards.<sup>74</sup> These regulatory liquidity standards ensure that any non-cash instruments can be quickly converted into cash to meet the Covered Company's obligations when clients seek to withdraw funds.<sup>75</sup> As such, segregated client assets have, in substance, analogous liquidity and funding characteristics to the traditional currency and coin of a banking organization.

Assigning an RSF factor other than 0 percent to segregated client assets would produce counterintuitive outcomes. For example, if the RSF factor is based on the underlying investment within the segregated account, Covered Companies would be incentivized to maintain such balances in non-cash form (*e.g.*, as U.S. Treasury securities) rather than in deposit accounts at

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<sup>71</sup> The Associations have noted that including segregated client assets in the SLR's exposure measure is counterintuitive, as such assets reduce the banking organization's credit exposure to its client, rather than increase exposure that should be capitalized.

<sup>72</sup> NSFR Proposed Rules § 106(a)(1).

<sup>73</sup> Basel NSFR Framework ¶ 36(a).

<sup>74</sup> 17 C.F.R. § 1.25; 17 C.F.R. § 240.15c3-3.

<sup>75</sup> Although the Agencies did not discuss segregated client assets in this context in the Proposed Rule, such assets may separately qualify as interdependent assets (matched with client-facing liabilities), as those concepts are described in Paragraph 45 of the Basel NSFR Framework. For purposes of this letter, however, we have instead focused on the RSF factor that should apply to segregated client assets absent interdependent transaction status.

unaffiliated custodians (*e.g.*, as “loans” to financial institutions). Since placing cash at an unaffiliated custodian would attract a 15 percent RSF factor, the Covered Company could reduce its RSF obligation by two-thirds, to 5 percent, simply by converting the cash into U.S. Treasury securities. While U.S. Treasury securities are certainly a liquid asset, it would be odd to penalize Covered Companies for maintaining segregated client asset balances in cash, since repaying client-facing liabilities would require the Covered Company to first convert any U.S. Treasury securities into cash. As a result, the RSF factors, which were developed for application to the general balance sheet assets of a Covered Company, do not apply in a sensible manner in this context, unless segregated client assets are treated as currency and coin.

Furthermore, we note that the treatment of segregated client assets does not appear to have been considered in the development of the Basel NSFR Framework—neither the January 2014 proposal nor the October 2014 final version contains any references to the treatment of such positions. Subsequent to the Agencies’ publication of the proposed rule, the Basel Committee issued an FAQ answer addressing the treatment of segregated client assets, but the Basel Committee’s guidance only provides that such assets “should be reported in accordance with the underlying exposure,” which would be consistent with classifying cash and cash-like segregated client assets as currency and coin for these purposes.<sup>76</sup>

Finally, we believe that the broader regulatory context of this recommendation is important. Imposing an artificial NSFR penalty on cash placed at unaffiliated custodian banks creates a conflict with the LCR, which recognizes that stress period client outflows can be matched against segregated asset balances.<sup>77</sup> In addition, the LCR requires the deposit-taking banking organization to assume 100 percent outflows for any non-operational deposits placed by a financial institution counterparty.<sup>78</sup> Penalizing segregated client assets held in cash form also would be at cross-purposes with the regulatory frameworks of the SEC and CFTC, which seek to encourage the strongest possible cash position of broker-dealers and futures commission merchants.

**7. Commodities traded on a non-U.S. exchange should be assigned an 85 percent RSF factor, consistent with the treatment of commodities traded on a U.S. exchange.**

The proposed rule would assign an 85 percent RSF factor to commodities traded on a U.S. board of trade or trading facility designated as a contract market (“DCM”) under sections 5 and 6 of the Commodity Exchange Act (“CEA”) or on a U.S. swap execution facility (“SEF”)

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<sup>76</sup> See Basel Committee, *Basel III – The Net Stable Funding Ratio: frequently asked questions* (July 2016), Question 23. The Basel Committee’s guidance on this issue raises the same procedural concerns summarized in Part II of this letter related to the absence of any meaningful opportunity to comment on, or receive information substantiating the underlying empirical basis of, the guidance.

<sup>77</sup> LCR rule §\_.33(g).

<sup>78</sup> LCR rule §\_.32(h)(2).

registered under section 5h of the CEA, and a 100 percent RSF factor to all other commodities held by a Covered Company. Because this formulation would apply a 100 percent RSF factor to commodities traded on exchanges that are registered in another jurisdiction, we respectfully request that the platforms eligible for an 85 percent RSF factor be expanded to include non-U.S. exchanges that are registered in a non-U.S. jurisdiction. The rationales provided by the Agencies for assigning a lower 85 percent factor to commodities traded on an exchange—that is, because exchange trading indicates a greater degree of standardization, fungibility and liquidity and exchange-traded commodities generally have enhanced price transparency—apply with equal force to commodities that are traded on non-U.S. exchanges. Therefore, in light of the fact that commodities traded on non-U.S. exchanges have similar liquidity characteristics to commodities traded on U.S. exchanges, the RSF factor assigned to these commodities should mirror the 85 percent RSF factor applicable to those traded on U.S. exchanges.

**8. The proposed rule should mirror the treatment of commitments under the LCR rule by permitting a Covered Company to take into account collateral that is received by the Covered Company to secure its commitment.**

The LCR rule permits a Covered Company to take into account the amount of Level 1 HQLA and Level 2A HQLA that secures the undrawn amount of a committed credit facility or committed liquidity facility for purposes of determining the related outflow amount for these commitments. However, under the proposed rule, the undrawn amount of a committed credit facility or committed liquidity facility is defined to include the entire unused amount of the facility that could be drawn upon, without any explicit provision permitting the Covered Company to take into account Level 1 HQLA or Level 2A HQLA that secure the undrawn amount of the commitment.

We do not believe there is a compelling analytical justification for diverging from the LCR rule and excluding the value of Level 1 HQLA and Level 2A HQLA received by the Covered Company as collateral that secures the commitment. If anything, there is more support for permitting a Covered Company to net the undrawn amount by the amount of collateral in the form of Level 1 HQLA and Level 2A HQLA in the context of the NSFR, in light of the fact that the NSFR is a structural metric calibrated over a one-year time horizon. We therefore believe that the Agencies should conform to the provisions under the LCR rule in this regard and explicitly permit Covered Companies to take this collateral into account in determining the undrawn amount of a committed credit facility or committed liquidity facility to which the applicable RSF factor must be applied.

**D. For purposes of determining the “excess” ASF amount of a consolidated subsidiary, the Agencies should further clarify that intercompany transactions between a Covered Company and its consolidated subsidiary when such transactions qualify as regulatory capital of the subsidiary are not taken into account.**

Under Section \_108(a) of the proposal, a Covered Company may include ASF of a consolidated subsidiary of the Covered Company up to (i) the RSF amount of the consolidated subsidiary *plus* (ii) any amount in excess of the RSF amount of the consolidated subsidiary to the extent the consolidated subsidiary may transfer assets to the top-tier Covered Company, taking into account statutory, regulatory, contractual or supervisory restrictions, such as Sections 23A and 23B of the Federal Reserve Act and Regulation W. It is further provided that, for purposes of calculating this “excess” amount, ASF amounts associated with a consolidated subsidiary refer to those amounts that would be calculated from the perspective of the Covered Company and that, when calculating the ASF amount of a consolidated subsidiary that can be included in the Covered Company’s consolidated ASF amount, the Covered Company would not include certain transactions between consolidated subsidiaries that are netted under U.S. GAAP.<sup>79</sup>

We believe that, in the context of a consolidated depository institution subsidiary that, on a standalone basis, would have RSF equal to \$90 (\$85 of which is external facing and \$5 of which is an intercompany asset) and ASF equal to \$100 (in which \$90 of the subsidiary’s funding is in the form of external deposits and \$10 of its funding is capital contributions from the parent holding company to the depository institution subsidiary), the foregoing means that the “excess” ASF for the subsidiary would be \$5 because the intercompany asset and the capital contributions from the parent holding company are each netted from the holding company’s perspective under GAAP. As a result, assuming that there is no regulatory capacity to transfer the \$5 to the parent company, this \$5 would be deducted from the consolidated ASF of the parent company and the intercompany asset and the capital contribution, which are already not included in the consolidated RSF and ASF framework, are netted consistent with applicable accounting rules.<sup>80</sup>

The Associations believe that this prescribed approach appropriately aligns with the NSFR’s overall balance sheet approach. More specifically, this approach appropriately aligns with the accounting treatment of intercompany assets, liabilities, and equity from the perspective of the Covered Company by reflecting the fact that transactions between itself and, or among, consolidated subsidiaries, including regulatory capital elements, long-term debt, and

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<sup>79</sup> See NSFR Proposed Rules, at 35,155, fn. 89.

<sup>80</sup> Of course, for purposes of the subsidiary bank’s calculation, to the extent that the NSFR is ultimately applied to the subsidiary bank, any equity contributed by its parent will be counted as ASF. As noted in the proposal, the ASF of a subsidiary calculated from the perspective of the parent may not be the same as the ASF calculated from the perspective of the subsidiary.

intercompany deposits, are already netted under applicable accounting rules and therefore should not be considered as part of the subsidiary “excess” ASF calculation.

**E. The Agencies should not apply the NSFR separately to the depository institution subsidiaries of a Covered Company.**

The proposed rule would apply the NSFR to both Covered Companies and to the consolidated subsidiaries of Covered Companies that are depository institutions with \$10 billion or more in total consolidated assets. This element of the proposed rule fails to recognize that available funding within a corporate group under the typical bank holding company structure in the United States may be used to satisfy funding needs elsewhere in the corporate group—including the needs of subsidiary depository institutions.

Under the typical bank holding company structure, which, in some cases, may involve multiple depository institution subsidiaries, the parent bank holding company uses an intragroup funding model in which the holding company generally holds liquid assets and has the ability to transfer these liquid assets in its subsidiaries (including its depository institution subsidiaries) as necessary for the liquidity management of the enterprise. The Federal Reserve’s regulation on enhanced prudential supervision requirements adopted pursuant to Section 165 of Dodd-Frank also provides certain prudential liquidity requirements for the parent bank holding company that includes this type of intragroup funding.<sup>81</sup>

We do not believe that any regulatory or supervisory purpose would be advanced by applying the NSFR separately to depository institution subsidiaries of a Covered Company.

First, insured depository institutions have a number of prudential restrictions that require stable funding models and, indeed, limit the amount of short-term non-deposit funding that it may seek. Insured depository institutions are required, and encouraged, to fund themselves in large part through deposits, which are a preferred funding source under the NSFR framework. In addition, to the extent an insured depository institution’s funding balance becomes mismatched, the primary Federal regulator will often impose prudential limits on less stable funding sources, such as brokered deposits.

Second, it has been the longstanding policy of the Federal Reserve that bank holding companies, including those that are Covered Companies (“Covered Bank Holding Companies”), must serve as a “source of strength” with respect to their depository institution subsidiaries.<sup>82</sup> Acting as a source of financial strength under this longstanding doctrine would logically apply to the resources that are required to meet the funding needs of a Covered Company’s depository institution subsidiaries, and a Covered Bank Holding Company is thus already obligated to

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<sup>81</sup> Regulation YY, 12 C.F.R. § 252.34(e)-(h).

<sup>82</sup> Dodd-Frank Act § 616; Regulation Y, 12 C.F.R. § 225.4(a)(1).

ensure that its depository institution subsidiaries have sufficient liquidity resources to meet its obligations.

Third, to the extent that there is any residual concern on the part of the Agencies with respect to the funding and liquidity resources available to or the funding position of a subsidiary depository institution of a Covered Company, we believe that it could be adequately addressed pursuant to a Pillar II supervisory approach that would not require Covered Bank Holding Companies to perform an additional subsidiary-level calculation that may inappropriately trap liquidity in a subsidiary, which could increase liquidity risk both with respect to individual institutions and as a systemic matter across the banking sector.

Given these prudential requirements, the imposition of a separate calculation requirement for subsidiary insured depository institutions would significantly reduce the overall operational burden associated with the NSFR framework. Likewise, eliminating the requirement to calculate the NSFR at the subsidiary depository institution level would thus properly recognize that these institutions are already encouraged to have stable funding sources and that available funding within a corporate group under the holding company structure is available to and may be used to satisfy funding needs elsewhere in the corporate group—including subsidiary depository institutions—subject to other applicable regulatory requirements such as Section 23A of the Federal Reserve Act and general principles of safety and soundness.

In addition, in requiring individual subsidiary depository institutions to calculate the full NSFR, the proposed rule does not adequately recognize the relationship between consolidated depository institutions that are subsidiaries of the same holding company (“sister banks”). In its calibration of the ASF factors, however, the proposed rule does not adequately take into account the relationship between sister banks, which is unique to the structure of banking organizations—and the related regulatory framework—in the United States.

Thus, to the extent the Agencies retain a separate calculation for large subsidiary depository institutions, we believe that the Agencies should revise the proposed rule such that any funding provided by a depository institution to a sister bank is afforded a higher ASF factor at the receiving bank, in recognition of the fact that, all other factors being equal, funding provided by an affiliated depository institution to a sister bank is more stable, including a corresponding increase in the RSF factor for the sister bank providing the funding. At a minimum, a higher ASF floor is warranted under circumstances where the affiliated depository institution providing the funding has an NSFR greater than 1.0 on a standalone basis. We believe it would be appropriate to limit this adjusted ASF treatment to circumstances where transactions between the two institutions qualify for the “sister bank exemption” under Sections 23A and 23B of the Federal Reserve Act (*i.e.*, transactions between two depository institutions if the same company owns at least 80 percent of the voting securities of both depository institutions).

Revising the ASF factor for funding provided by a sister bank would better reflect the nature of intercompany funding between sister banks in a holding company structure. It also



would be consistent with the principles set out in Sections 23A and 23B of the Federal Reserve Act and the cross-guaranty liability provisions of the Federal Deposit Insurance Act, both of which recognize the distinct relationship between sister banks in the U.S. bank regulatory framework.

**F. Although the Agencies did not provide a framework for the treatment of interdependent assets and liabilities, we believe that certain transactions should be eligible for more appropriate treatment under the NSFR due to their economic substance.**

The proposal asserts that U.S. banking organizations do not engage in transactions that would appear to meet the criteria for recognition of interdependent assets and liabilities (*i.e.*, “linked transactions”), as described in the Basel NSFR Framework.<sup>83</sup> However, there are several categories of clearly defined transactions, particularly in the capital markets, in which banking organizations act as intermediaries to facilitate client investing and trading. In these cases, responsible ALM practices require banks to carefully align and offset associated assets and liabilities to minimize the risk of funding gaps, among other considerations. One of the major conceptual and operational weaknesses of the Basel NSFR Framework is that, absent the linked transaction category, it evaluates assets and liabilities in isolation from one another, which no responsible banking organization would do in practice. The linked transaction category provides a potential corrective fix to this important weakness.

The Associations and market participants have in the past recommended a range of potential transaction categories that should qualify for more favorable linked transaction treatment under the NSFR, with a particular focus on the capital markets. While we continue to believe that these transactions reflect responsible ALM practices and should benefit from an NSFR exclusion, we have chosen to focus on only two sample transaction categories herein.

**1. Initial margin-funded hedge securities for derivatives.**

Clients oftentimes seek exposure to an underlying reference asset through a derivative contract and banking organizations play a vital role in providing clients with exposures to securities through these instruments. In this example, the Covered Company will execute a derivative contract with its client, providing the client with long exposure to the reference asset. Because the derivative contract provides the client with long exposure, the bank, as the derivative contract counterparty, has short exposure in the derivative contract to the reference asset. The Covered Company can hedge market risk created by the derivative contract by purchasing the reference asset, thus balancing its short position (in the derivative contract) with its long position (the reference asset held by the Covered Company as a market risk hedge).

In some instances, the client will provide the Covered Company with initial margin in the form of cash which the Covered Company can use to meet part or all of the purchase cost of the

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<sup>83</sup> See Basel NSFR Framework ¶ 45.

reference asset. The cash received from the client is accounted for as a liability by the Covered Company (a client payable); the hedge asset purchased with the initial margin is accounted for as an asset by the Covered Company. When the client seeks to terminate the position, the Covered Company will sell the hedge security (receiving cash) and terminate the swap with the client (resulting in the return of cash initial margin to the client). This transaction structure is particularly common for clients seeking exposure to equity securities, and we use equity swaps as an example below.

To illustrate, suppose that the Covered Company's client seeks long exposure to shares of ABC equity securities. The Covered Company executes an equity-based swap with the client and hedges its market risk in the swap by purchasing 100 shares of ABC equity securities at \$1/share for a total cost of \$100. The Covered Company's client provides initial margin at the outset of the contract to cover a portion of the cost of purchasing the hedge equity securities (say, \$20). At close-out, the Covered Company's position on the client-facing equity swap will correspond to the sale price of the market risk hedge equity securities, and the Covered Company will return the \$20 initial margin to the client.

In this example, the interdependent assets and liabilities would be \$20 of shares of ABC equity securities (asset) and the \$20 of initial margin received (liability). While the Covered Company has total assets of \$100 in equity securities related to the transaction, only the amount funded by the client's initial margin would be eligible for linked transaction status, since this is the "clearly identifiable" asset amount that corresponds to the value of the funding liability.

The Covered Company in this example is acting as an intermediary to provide the client with exposure to the equity securities and transform the initial margin funding received from the client into a hedge position for the Covered Company, with both the funding liability and the hedge asset unwinding concurrently at close-out. In cases where the initial margin cannot be, or is not actually, used as funding for the hedge asset, linked transaction status would not be warranted.

The proposal considers a version of this transaction example and concludes that the linked transaction criteria in the Basel NSFR Framework are not met. In particular, the proposal questions whether: (i) the liability funding the equity securities could fall due while the equity securities remain on the Covered Company's balance sheet; (ii) the maturity of the equity securities and the liability funding the equity securities are the same, since equity securities have perpetual maturity and the liability could have a short-term maturity; and (iii) the Covered Company is acting solely as a pass-through unit to channel the funding received (in the proposal, the Agencies cite repurchase agreements rather than initial margin as a funding source).<sup>84</sup>

In response, we note that a combination of relatively simple contractual provisions, auditable internal policies and procedures, and demonstrable business practices appropriately

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<sup>84</sup> NSFR Proposed Rules, at 35,156.

address the Agencies' stated concerns. For example, many client-facing derivative contracts include *force majeure* or similar market disruption provisions that permit banking organizations to delay settlement of the derivative contract if the banking organization is unable to sell the market risk hedge securities related to the contract. Such contractual arrangements establish a direct link between the client-facing liability and the hedge security asset; as a result, the Covered Company will not be immediately forced to return initial margin (and close out the liability) if it is unable to sell the hedge securities (and close out the asset). Recognition of initial margin could be limited to circumstances where such *force majeure* or similar market disruption contractual provisions exist.

In addition, Covered Companies could adopt auditable internal policies and procedures that would ensure initial margin liabilities and hedge security assets are appropriately linked for operational purposes. Such policies and procedures might, for instance, require that the Covered Company sell equity hedge securities when a client closes out an equity swap to the extent such hedge securities are funded by the client's initial margin. In this case, internal policies and procedures, supported by reporting metrics and Agency oversight, would have the same practical effect as a contract with the client, thereby ensuring that the liability funding the equity securities could not fall due while the equity securities remain on the Covered Company's balance sheet.

We believe that it is important to emphasize that this recommendation is limited to circumstances in which a Covered Company has received initial margin that can be used, legally and contractually, as a funding source for the hedge securities, not to circumstances (as assumed in the proposed rule) in which the Covered Company funds the hedge securities through repurchase agreements. As such, the Covered Company is acting as a "pass-through unit,"<sup>85</sup> directly transforming client margin into funding for the client-facing derivative hedge security.

We agree with the Agencies that, at least in the case of equity swaps, as a technical matter the maturity of the hedge instrument (perpetual) will not always align with the maturity of the liability (which may have either an open or a fixed-term maturity). However, from a funding perspective, the effective maturity of the two positions for the Covered Company will align, insofar as the Covered Company sells the hedge security upon termination of the swap and return of the initial margin. More generally, and further to our comments above about the lack of appropriate process in the development of the NSFR, it is not clear why the maturity of the underlying instrument itself is even relevant for prudent ALM if the Covered Company has the practical ability, and intends, to close out the asset and liability concurrently.

As a policy matter, and setting aside the linked transaction criteria in the Basel NSFR Framework, it would be an odd outcome for the final U.S. rulemaking to derecognize initial margin as a funding source for hedge securities on client derivatives while incentivizing banking organizations to instead rely on retail customer deposits, which receive up to 100 percent ASF

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<sup>85</sup> The term "pass-through unit" is not defined in the Basel NSFR Framework and we are unaware of any other Basel standards that rely on the term. Accordingly, we have interpreted the term consistently with general ALM principles.

recognition, as a funding source for derivatives. Where permitted by applicable recognition, initial margin is uniquely well-suited to help cover the funding costs associated with a client's derivatives portfolio, since the funding source is directly linked to the funding needs arising from the activity. In addition, when a Covered Company buys a long position in the relevant equity security, it is actually financing corporate entities by holding the corporate equity of those entities; punitively charging this structure would thus also have a negative impact on corporate financing.

Finally, we do not believe that this treatment is precluded by recent Basel Committee guidance stating that linked transaction treatment “is not intended to be applied to derivative transactions.”<sup>86</sup> To be clear, we are not arguing that derivative liabilities are linked to derivative assets. In fact, we agree with the Basel Committee that a derivative liability arising from one QMNA netting set is generally not interdependent with a derivative asset arising from a second QMNA netting set (or any other balance sheet asset). In this case, however, the proposed assets and liabilities are hedge securities and initial margin payables, respectively.

## 2. Client short transactions.

Clients regularly seek to “short” securities as part of their normal course investment and risk management strategies and banking organizations help to facilitate market liquidity by executing long and short positions for clients. When facilitating settlement of a client short transaction, the banking organization<sup>87</sup> receives short sale proceeds for the client's short sale (creating a liability) and delivers cash collateral to the securities lender (creating an asset). To settle a short transaction entered into by a client (and thus receive short sale proceeds), the banking organization must deliver shares of the security shorted by the client to the securities purchaser.<sup>88</sup> We believe that linked transaction status should apply to cases where short sale proceeds support the banking organization's ability to provide cash collateral to source securities from external securities lenders.<sup>89</sup> Even beyond facilitating client activity, when Covered Companies facilitate these short positions they are promoting market liquidity. It is therefore important that any final NSFR requirement “get it right” to avoid dramatic decreases in market liquidity and the broader financial stability concerns that such a decrease would create.

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<sup>86</sup> Basel Committee, *Basel III – The Net Stable Funding Ratio: frequently asked questions*, p. 2-3 (July 2016) (Answer to Question 9).

<sup>87</sup> In practice, a broker-dealer subsidiary of the banking organization will generally facilitate the transaction.

<sup>88</sup> See generally U.S. Securities and Exchange Commission, “Fast Answers: Short Sales,” available at: <http://www.sec.gov/answers/shortsale.htm>.

<sup>89</sup> Although external securities lending arrangements take many forms, they may involve either an agent lending securities on behalf of its underlying principals or, alternatively, beneficial owners of securities lending securities directly to the banking organization. In either case, the banking organization borrowing the securities will record an asset for the value of cash collateral delivered to the external securities lender in exchange for borrowing the security.

When a banking organization obtains securities from a securities lender to effectuate a client short transaction, interdependent liabilities and assets are created: the client short sale proceeds received by the banking organization are a liability, and the cash provided to the securities lender as collateral for borrowing the cover securities is an asset. The liability and the asset are created in tandem as part of the short sale settlement process. At the close-out of the client's short transaction, the client must return the shorted security to the banking organization in order for the banking organization to provide the short sale proceeds to the client, which closes the liability. In turn, the banking organization returns the security to the lender and receives the cash collateral back from the securities lender, closing out the asset.

The proposal considers a version of this transaction example and concludes that the linked transaction criteria in the Basel NSFR Framework are not met. In particular, the proposal questions whether: (i) the interdependence of the asset and liability may be established on the basis of contractual arrangements; (ii) whether the liability could fall due while the asset remained on the balance sheet; and (iii) whether the maturity and principal amount of both the interdependent liability and asset are the same.<sup>90</sup>

In response to these objections, we believe that there are three overarching considerations that the Agencies may not have considered. First, under the Federal Reserve's Regulation T, a U.S. broker-dealer may only borrow securities if it has a "permitted purpose,"<sup>91</sup> such as to obtain securities for delivery in connection with a client's short sale. The so-called permitted purpose requirement, in effect, creates a regulatory linkage that permits a broker-dealer to create the cash collateral asset only where there is an underlying associated customer short sale liability, and the broker-dealer is not permitted to indefinitely retain the borrowed security in the absence of client demand. In other words, contractual arrangements demonstrating interdependence of assets and liabilities arise where such arrangements are subject to Regulation T.

Second, after publication of the Basel NSFR Framework, the Basel Committee published a second framework that directly addresses liquidity risk in securities borrowing transactions.<sup>92</sup> While the Basel SFT Floors Proposal imposes a general requirement that banking organizations must receive excess securities collateral when providing cash on a secured basis to a counterparty, the framework includes a special treatment for securities borrowing transactions, since securities lenders are typically over-collateralized by cash (and therefore the banking organization provides more cash than it receives as securities collateral). In response, the Basel SFT Floors Proposal recognizes an exemption from the bank's collateralization requirements "if the lender of the securities reinvests the cash collateral into a reinvestment fund or account subject to regulations or regulatory guidance meeting the minimum standards for reinvestment of

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<sup>90</sup> NSFR Proposed Rules, at 35,156.

<sup>91</sup> In the absence of a permitted purpose, the broker-dealer would be required to apply Regulation T margining requirements. See 12 C.F.R. § 220.10.

<sup>92</sup> Basel Committee, *Haircut floors for non-centrally cleared securities financing transactions* (Nov. 2015) ("Basel SFT Floors Proposal").

cash collateral by securities lenders,” with exact reinvestment criteria described elsewhere in the framework.<sup>93</sup> We believe that the Basel SFT Floors Proposal provides important context for the NSFR, since it directly addresses the risk that a banking organization might be unable to receive cash collateral back from the securities lender when the banking organization seeks to close out its asset. In effect, the reinvestment standards imposed by the Basel SFT Floor Proposal provide an ALM tool to help the banking organization manage the flow of cash collateral back from the securities lender, which matches the banking organization’s obligation to pay cash short sale proceeds to the client. Accordingly, we believe that securities borrowing transactions complying with the reinvestment exemption standards in the Basel SFT Floors Proposal should receive linked transaction status.

Third, as in the case of initial margin-funded derivatives, any remaining concerns about asset-liability linkage could be addressed through auditable internal policies and procedures and demonstrable business practices, as evidenced in reporting metrics. Such internal policies and procedures could require, for instance, that a banking organization promptly initiate return of the borrowed security to obtain any cash collateral provided to securities lenders when the associated client short position is closing, thereby further ensuring that the liability cannot fall due while the asset remains on the balance sheet. Banking organizations implementing this approach could then provide data to the Agencies demonstrating that, in practice, there is actual matching between client short sale liabilities and cash collateral assets. To the extent that there is ever a mismatch, the banking organization would be required to de-recognize linked transaction treatment and apply an RSF factor to the asset amount.

Finally, the proposal also questioned whether maturity and principal amounts of the interdependent asset and liability are the same in client short coverage transactions. To the extent that both the client short and securities borrowing transactions are overnight (or open) maturity, the maturities will be the same. The principal amounts will be nearly the same, although there will typically be small differences between the value of short sale proceeds and cash collateral provided (*e.g.*, in U.S. market practice, a broker-dealer may provide \$102 of cash collateral to borrow securities covering a \$100 client short position). Any small discrepancy in the values of the asset and liability, however, could be addressed by recognizing linked transaction status for the asset only up the value of the liability. For example, in the \$102/\$100 example above, the banking organization would have to apply an RSF factor against the “excess” asset amount of \$2.

We therefore urge the Agencies, at minimum, to consider linked transaction treatment for the foregoing defined assets and liabilities.<sup>94</sup> To the extent that such recognition should be based on the existence of auditable internal policies and procedures and demonstrable business practices, we would welcome an opportunity to discuss specific standards with the Agencies.

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<sup>93</sup> Basel SFT Floors Proposal ¶ 143(iv).

<sup>94</sup> *See* Basel NSFR Framework ¶ 45.

More generally, however, our recommendations are intended to improve the ALM sensitivity of the NSFR, and other approaches might achieve the same substantive objectives through different technical solutions that do not require formally recognizing linked transactions. Such approaches might include reducing derivative net assets by the amount of reusable initial margin received from clients, in recognition of the direct funding value provided in support of derivatives; adjusting derivatives net asset or derivatives hedge security RSF factors to reflect the remaining maturity of the derivatives netting group, thereby distinguishing between funding requirements for short- and long-dated derivatives; or other adjustments to RSF factors for cash collateral provided to securities lenders or derivative hedge securities to reflect underlying ALM principles, without explicitly basing such adjustments on linked transaction criteria.

We believe that appropriate accommodations, whether through formal linked transaction status or otherwise, are justified in the case of capital markets activities, given the procedural deficiencies in the Basel process and the lack of independent justification or rationale in the proposal for many of the most severe calibrations beyond a stated desire to align with Basel standards.

Finally, we note that, given that firm short transactions present comparable economic liquidity characteristics as client short transactions described above—that is, the transactions are similarly self-funding as the proceeds from the firm short transaction cover the liquidity risk—they merit similar revised treatment as an analytical matter.<sup>95</sup>

**G. *A de minimis* exception to the requirement that a Covered Company notify the appropriate Agency of an NSFR shortfall is appropriate for the NSFR.**

A Covered Company would be required to notify the appropriate Agency of an NSFR shortfall, or potential shortfall, generally no later than 10 business days following the date that any event occurs that has caused or would cause the Covered Company's NSFR to fall below the minimum requirement.<sup>96</sup> The Agencies request comment as to whether a *de minimis* exception to an NSFR shortfall should be implemented such that a Covered Company would not need to report such a shortfall provided its NSFR returns to the required minimum within a “short grace period.”<sup>97</sup> The Associations believe that such an exception for NSFR shortfalls is indeed appropriate. A *de minimis* exception—particularly when considered together with the “ongoing compliance” requirement in the proposed rule—would make appropriate allowances for a range of circumstances where the cause of a shortfall is beyond a Covered Company's control and would not be expected to pose systemic risk in light of the expected short duration and minimal amount of the shortfall.

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<sup>95</sup> Firm short transactions are treated separately from other reverse repo transactions under the LCR rule for similar reasons (*i.e.*, they are cash neutral).

<sup>96</sup> See NSFR Proposed Rules, at 35,157.

<sup>97</sup> See NSFR Proposed Rules, Question 52, at 35,157.

In addition, consistent with other recent rulemakings,<sup>98</sup> the final NSFR rule should include a cure period specifically with respect to shortfalls that result solely due to the merger or acquisition by a Covered Company or a consolidated subsidiary with another company. Such transactions may impact a Covered Company acquirer's balance sheet such that the Covered Company would be temporarily out of compliance with the NSFR requirement following the close of the transaction. In light of the fact that any Covered Company contemplating such a merger or acquisition would necessarily enter into a discussion of potential regulatory and supervisory issues with the Agencies in advance as part of the regulatory approval process for the transaction, the relevant Agency with supervisory oversight of any such transaction would have the ability to monitor the balance sheet impact and any temporary NSFR shortfall associated with the transaction to ensure that the Covered Company has planned appropriately to remedy any NSFR shortfall by adjusting the resultant funding profile of the post-transaction consolidated balance sheet within an appropriately limited timeframe post-acquisition.

**H. The effective date of January 1, 2018 as currently proposed does not afford Covered Companies adequate implementation time with respect to several aspects of the proposed NSFR calculation requirements.**

The calculations required to assure compliance by Covered Companies with the NSFR on an ongoing basis under the proposed rule are complex, and significant incremental investments of time and resources will be required for these banking organizations to design, develop and implement the internal processes and procedures necessary to fully implement the proposed rule in accordance with regulatory expectations. We believe that the effective date of January 1, 2018 as currently proposed does not afford Covered Companies adequate implementation time with respect to several aspects of the proposed NSFR calculation requirements.

In particular, implementation of the proposed rule will require the dedication of significant firm management, compliance and information technology resources, expertise and personnel in an environment where Covered Companies are already involved in a number of other projects responsive to regulatory initiatives. There are practical limitations on firms' ability to simultaneously manage and implement a wide variety of regulatory standards, each of which requires changes to processes and systems. Given the scope and extent of the resources and the complex information technology and operational systems that would be required to implement the proposed rule, as well as the range of existing regulatory projects already under way, we believe that permitting firms additional time would allow them to more carefully and deliberately expand and upgrade existing processes and systems to ensure compliance. This is particularly the case due to the novelty of the NSFR standard in comparison to existing liquidity regulations and the bespoke systems that would be required to be responsive to the provisions of the proposed rule.

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<sup>98</sup> See Federal Reserve, *Proposed Rule: Single-Counterparty Credit Limits for Large Banking Organizations*, 81 Fed. Reg. 14238, 14356 (Mar. 16, 2016).



Beyond systems and processes that will be required, significant lead time will be necessary for a banking organization to make any necessary or desired structural adjustments to its balance sheet for those Covered Companies that wish to move their NSFR ratios from their current level. It takes time for banking organizations to develop and implement a strategy for raising long-term stable funding and such structural modifications to the balance sheet must necessarily be implemented gradually over time. We therefore respectfully request that the Agencies delay the compliance date to no earlier than two years following publication of a final NSFR rule in the Federal Register.<sup>99</sup>

Furthermore, if the Agencies choose to apply the NSFR requirement as proposed separately to depository institution subsidiaries, it will be important for each of the Agencies and Covered Companies to fully understand the full ambit of requirements that will be introduced in the Agencies' final TLAC rule and the implications with respect to any so-called internal TLAC requirement that may be proposed in the future.<sup>100</sup> As such, any finalization and implementation of a NSFR requirement in the United States should not occur until such time as the U.S. TLAC standards, including any internal TLAC requirements, are otherwise completed in order to ensure that the two regimes are properly harmonized.

**I. A Covered Company should be permitted to calculate its NSFR in the same manner as it calculates its regulatory capital requirement.**

The proposed rule provides that a Covered Company would be required to maintain an NSFR equal to or greater than 1.0 “on an ongoing basis.” Importantly, in contrast to the LCR rule, which specifies that a Covered Company must calculate and maintain an LCR that is equal to or greater than 1.0 “on each business day” and that a Covered Company must calculate its LCR as of the same time on each business day, here the Agencies did not specify how frequently a Covered Company must perform these calculations. Given that the NSFR is explicitly a balance sheet measure that is necessarily computed on a periodic basis similar to the manner in which risk-based and total assets are determined under the regulatory capital rules, it is appropriate for a Covered Company to calculate its NSFR in the same manner as a banking organization calculates its regulatory capital ratios. Specifically, in contrast to the LCR, which focuses on the quantity of particular assets and net inflows and outflows over a stressed 30-day period, the NSFR is intended to be a longer-term structural metric measured primarily by reference to a Covered Company's balance sheet. It is thus not feasible for a Covered Company to produce exact measures of each of the various components of the NSFR that can be tied out to the Covered Company's balance sheet or Call Report on a more frequent basis than monthly because certain balance sheet items are calculated for internal reporting purposes only on a

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<sup>99</sup> See NSFR Proposed Rules, at 35,166.

<sup>100</sup> See Federal Reserve, *Proposed Rule: Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations; Regulatory Capital Deduction for Investments in Certain Unsecured Debt of Systemically Important U.S. Bank Holding Companies* (Nov. 30, 2015).

periodic basis. We thus believe that it would be appropriate for a Covered Company to calculate its NSFR in the same manner as it calculates its regulatory capital requirement and request the Agencies confirm this understanding. We note that the requirement to notify the Agencies in the event of a shortfall (subject to the *de minimis* exception described in Part III.G., above) would nevertheless be retained.

**IV. The imposition of the NSFR may have negative consequences for the broader economy—including through the reduction in the supply of credit by banking organizations—and may add further to a deterioration in market liquidity.**

It is undeniable that, at some point, financial regulation—which is not a cost-free proposition—can reach a point at which additional measures become counterproductive. We may have already crossed over that line. There is accumulating evidence that the implementation in the United States of the SLR and the G-SIB Surcharge have already led to a sharp reduction in banking organizations’ intermediation in financial markets and a significantly reduced ability of financial market participants to engage in transactions that promote price discovery and liquidity in financial markets. These changes, in turn, have led to deterioration in market liquidity—including a decrease in the size of the repo market—and an increase in volatility in markets that are essential to the U.S. and global economy. The market impacts of the cumulative effects of extant regulatory measures serve as a useful proxy and signal that additional regulatory initiatives aimed at the banking and financial sectors can and do produce outcomes that are counterproductive to regulatory objectives.

With respect to the NSFR, the Agencies have indicated that the aggregate shortfall in funding for all banking organizations subject to the NSFR or Modified NSFR is estimated to be \$39 billion, which is equivalent to 4.3 percent of the RSF for the banking organizations that would have an NSFR shortfall.<sup>101</sup> Even assuming, *arguendo*, the accuracy of these shortfall estimates, the negative market impacts of complying with the NSFR are likely to increase significantly over time as a result of the gradual normalization of the Federal Reserve’s balance sheet and financial markets generally and may become the binding constraint for many Covered Companies. If implemented as proposed, the NSFR would therefore increase both the foreseeable and the unintended consequences of the regulation on the U.S. economy and financial stability.<sup>102</sup> More specifically, such implementation would be problematic for several markets in which banking organizations facilitate client activity for transactions that are critical for economic growth and financial stability, and would likely have significant negative

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<sup>101</sup> In this respect, we note that it is unclear what data sources support the assertion in the proposed rule that there is an estimated NSFR compliance gap of \$39 billion across U.S. banking organizations, since standardized templates submitted in prior data submission exercises did not include many features unique to the proposed rule, such as incremental RSF factors applied to reused off-balance sheet collateral or imposition of Regulation W limits on the recognition of bank subsidiary funding.

<sup>102</sup> The Clearing House, *The Net Stable Funding Ratio: Neither Necessary nor Harmless* (July 2016), available at: [https://www.theclearinghouse.org/~/\\_media/tch/documents/20160705\\_tch\\_nsfr\\_note.pdf](https://www.theclearinghouse.org/~/_media/tch/documents/20160705_tch_nsfr_note.pdf).

consequences on the ability of banking organizations to provide critical credit intermediation to the market and the broader economy.

As an initial matter, the NSFR of Covered Companies is currently elevated by the unusual nature of the financial situation, including the large volume of reserve balances held at Federal Reserve banks and the elevated level of retail deposits at commercial banks, owing to the very low level of interest rates. If the Federal Reserve's balance sheet normalizes, in line with its own forecast, and if the economy evolves as forecasted, the industry-wide aggregate NSFR across Covered Companies will decline sharply over time to a level at which many subject banking organizations will become noncompliant, requiring them to make adjustments to their balance sheets. One likely response by banking organizations will be to shift their asset holdings from loans to non-financial businesses and households, which would typically require a large amount of stable funding under the proposed rule, toward securities, which would require much less stable funding. In order to counter just half of the projected decline in the NSFR, banking organizations would be forced to reduce projected loan growth from about four percent per year to about one-half of one percent per year.<sup>103</sup>

Going forward, the cumulative negative impact to the real economy of the NSFR as proposed is likely to manifest in a number of important respects:

First, the NSFR as proposed is likely to negatively impact the capacity of banking organizations to provide critical credit intermediation services to market participants. For example, in an impact study of the NSFR published by the EBA, the EBA conducted an analysis of banking organizations' shortfall with respect to specific business models and found that the securities trading businesses of the banking organizations surveyed would face a significant NSFR shortfall.<sup>104</sup> Banking organizations allocate capital and funding to activities across business lines based on the expected return of the particular activities, which calculation includes considering the impact of capital, leverage and liquidity regulations on discrete business lines.<sup>105</sup> In light of the NSFR shortfall that banking organizations would face in respect of these wholesale and capital markets activities, including derivatives, they would rationally reallocate resources according to such capital, leverage and funding costs—likely curtailing these important market-making and credit intermediation activities on a relative basis. Because it is often complicated—due to various risk management and business considerations—for a banking organization with a surplus in a particular business line in respect of capital, liquidity or funding

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<sup>103</sup> The Clearing House, *The Net Stable Funding Ratio: Neither Necessary nor Harmless* (July 2016), available at: [https://www.theclearinghouse.org/~media/tch/documents/20160705\\_tch\\_nsfr\\_note.pdf](https://www.theclearinghouse.org/~media/tch/documents/20160705_tch_nsfr_note.pdf).

<sup>104</sup> See EBA, *EBA Report On Net Stable Funding Requirements under Article 510 of the CRR*, p. 49 (Dec. 15, 2015).

<sup>105</sup> See Basel Committee, *Principles for Sound Liquidity Risk Management and Supervision*, p. 3 (Sept. 2008) (stating that “a bank should incorporate liquidity costs, benefits and risks in the internal pricing, performance measurement and new product approval process for all significant business activities (both on- and off-balance sheet), thereby aligning the risk-taking incentives of individual business lines with the liquidity risk exposures their activities create for the bank as a whole”).

(*e.g.*, retail banking) to transfer that benefit to other business lines facing a shortfall (*e.g.*, market-making), many banking organizations will elect not to subsidize the capital or funding costs of a particular business line. Instead, this shortfall is likely to lead to reduced capacity by banking organizations to participate in capital markets and market-making activities. Such a reduction in participation in these wholesale markets would likely decrease liquidity in primary and secondary market trading and increase transaction costs to end-users and other market participants, which would result in greater volatility, wider bid-offer spreads and reduced market efficiency.

Second, the NSFR is likely to create a negative feedback effect with respect to liquidity in the underlying cash markets—liquidity that has already been compromised by other existing regulations. For clearing of client transactions, the impact of the NSFR is likely to increase the cost of clearing and thereby lower returns of investor clients. This could, all else being equal, even prompt investor clients to avoid centrally cleared transactions and to return instead to uncleared OTC derivatives, thereby decreasing the effectiveness of derivatives reforms enacted following the recent financial crisis and increasing—rather than reducing—systemic risk. Within the cleared markets, banks would be incentivized to concentrate exposures with fewer CCPs, which would further increase systemic risk associated with cleared exposures.

Third, the NSFR would have significant adverse impacts on the derivatives markets and their end users. For example, Oliver Wyman has projected in a January 2015 study that the NSFR, as finalized at the Basel level, would require global banks to raise approximately \$500 billion of additional long-term funding to support OTC derivatives. Assuming that 25 percent of the new funding requirement can be absorbed by banks' existing stable funding that is in excess of the proposed NSFR minimums (a conservative estimate based on public data), and a 150-200 basis point increase in funding costs for the remaining \$375 billion in long-term funding that would be required, the new long-term funding requirements would result in \$5-8 billion in incremental costs to the industry. These incremental costs would result in increased fees of 10-15 percent for client-facing derivatives transactions based on an estimated \$50 billion cost base for the business.

Similarly, ISDA, the Global Financial Markets Association (“GFMA”) and the Institute for International Finance (“IIF”) have aggregated data from 12 banking organizations, representing approximately 45 percent of the global derivatives market based on notional value, submitted as part of the Basel Committee’s and Agencies’ QIS processes.<sup>106</sup> For these 12 banking organizations, the NSFR would require approximately €159 billion in additional stable funding due to the fact that the NSFR ignores the funding benefit of variation margin that does not meet the SLR criteria (as discussed in Part III.A). The NSFR would require approximately €153 billion in stable funding for the 12 banking organizations due to the 20 percent gross liabilities add-on. By extrapolating these numbers to the rest of the industry, we estimate that the

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<sup>106</sup> Of the 12 banking organizations, seven are based in Europe, four are based in the United States, and one is based in Asia.

NSFR's failure to recognize the funding benefit of all variation margin would result in an additional €353 billion in required stable funding, and the add-on would result in an additional €340 in required stable funding.<sup>107</sup> Both the Oliver Wyman study and the ISDA-GFMA-IIF study are based on the Basel NSFR Framework. Costs would increase even more in the United States under the proposed rule because of its more stringent framework.

In response to these negative impacts to the derivatives market, like any business, Covered Companies seeking to manage their costs would be strongly incentivized to pass along the costs of funding derivatives to end users, particularly those end users that enter into trades that present the greatest RSF requirements under the NSFR. Covered Companies may even be incentivized to cease entering into derivatives with end users that enter into NSFR-disadvantaged trades. Under the proposed rule, the most disadvantaged clients for NSFR purposes would be end users that (i) enter into long-dated derivatives trades, which have more opportunity to move directionally and therefore tend to create greater gross derivatives liabilities for the Covered Company for purposes of the 20 percent add-on and/or (ii) post variation margin in the form of securities, which would not reduce the Covered Company's derivatives assets. Corporates, insurance companies, pension funds, and mutual funds that enter into derivatives to hedge their commercial or investment risks fall into these categories. Perversely, these are the clients that are the least prone to default, that use derivatives for risk management rather than speculation, and that pay the least amount of fees due to the low frequency of their transactions. Adverse impacts on these types of clients also have the most spillover to the real economy, ultimately affecting consumers, workers, and retail investors.

Fourth, the NSFR also has the potential to make pricing less efficient, thereby impeding the ability of banking organizations to execute hedging transactions and impairing a key channel for risk-return optimization for market participants, including non-financial end users such as corporates and pension funds. Moreover, the higher carrying costs imposed by the NSFR—resulting in lower returns to investors, increased settlement risk and decreased liquidity—would negatively impact client short transactions that are also important for market efficiency and price discovery. Corporate and other end-user treasury functions (including, for example, transactions relating to ALM, funding and capital raising) may also become less efficient, thus impeding the flow of capital and investment in the real economy.

Fifth, the adoption of the NSFR is likely to reduce market efficiency and access for the segregation and custody of client assets. Investors' choices of service provider may very well be narrowed and transaction costs will increase as a result of the treatment of segregated assets under the proposed rule.

We are also concerned more generally that the proposed rule would require Covered Companies effectively to establish a buffer of funding in the form of highly liquid assets in order to meet the NSFR requirements—a sunk cost that will be reflected on the balance sheet of every

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<sup>107</sup> This extrapolation assumes that the rest of the market is subject to the NSFR.

Covered Company once structural adjustments have been made. For example, the proposed rule would require a Covered Company to hold stable funding against 20 percent of its gross derivatives liabilities to cover potential future exposures on its derivatives portfolio. This provision effectively requires a Covered Company to pre-fund the cost of potential future funding risks even if this funding risk is unlikely ever to materialize. As a practical matter, this funding must then be invested in relatively liquid assets that will attract a lower RSF requirement, which in turn consumes a banking organization's balance sheet, resulting in negative yield and a sunk cost to the organization. Moreover, to the extent that these funding risks do arise, the Covered Company would not be able to use this buffer of liquid assets and would instead be required to raise additional funding to remain in compliance with the NSFR. This feature of the proposed rule is especially unwarranted given that the NSFR is no longer intended to reflect funding needs during an extended period of stress, but rather to require stable funding across all market conditions. In addition to this conceptual flaw, this buffer requirement would effectively impose a sunk cost on certain transactions that would hinder further the capacity for banking organizations to perform critical functions in these markets.

The potential substantial economic costs of the NSFR have also been, quite tellingly, recognized by governmental bodies in other jurisdictions which have expressed serious misgivings regarding both the foreseeable adverse consequences and potential unintended consequences of implementing the NSFR as currently constructed. The EC has expressed concerns regarding the effect of the NSFR on the EU economy and the ability of EU banking organizations to provide financing that is necessary for economic growth in the EU. The EC noted that NSFR treatment of derivatives and short-term repurchase agreements, or "repos," could limit banks' access to funding sources and thereby decrease available funding to the broader EU economy. More specifically, there is a general focus in the EC NSFR consultation on "not unduly penaliz[ing] certain banking activities" and "limiting any excessive impact on bank lending" as well as "not hindering financing of [the] EU economy" with respect to NSFR treatment of derivatives and repos. With respect to the 20 percent RSF factor add-on for gross derivatives liabilities, the EC stated that "[t]here is a risk that the 20% RSF on gross derivatives liabilities could lack risk-sensitivity since it does not take into account the dynamics of the derivatives portfolio over one year and the evolution of the relationships between derivatives assets and liabilities for offsetting portfolios. As a result, it could under-estimate the future funding risk in some situations (*e.g.*, it would produce a small RSF when total derivatives liabilities are close to zero) and over-estimate it in others (*e.g.*, large, offsetting derivatives portfolios of major market-makers will be particularly impacted)."<sup>108</sup>

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<sup>108</sup> European Commission, *DG FISMA Consultation Paper on Further Considerations for the Implementation of the NSFR in the EU*, p. 4.

## V. Other Issues and Considerations

### A. LCR Definitions

1. **The definition of “Liquid and Readily-Marketable” should be revised to incorporate a straightforward, presumptions-based approach supplemented by additional analysis only for a limited pool of securities for which there is a legitimate question as to whether the security in fact has the requisite liquidity profile to be eligible HQLA.**

The Agencies have previously expressed interest in the challenges of implementing the “liquid and readily marketable” requirement (“LRM Requirement”) for securities to qualify as HQLA under the LCR rule in a workable and practical manner by banks, while limiting the potential for negative market consequences. To this end, The Clearing House has developed a proposed, presumptions-based approach for applying the LRM Requirement (the “TCH LRM Guidance”). Specifically, the TCH LRM Guidance identifies categories of securities that would be presumed to meet the LRM Requirement. For those categories of securities that would not presumptively meet the LRM Requirement, a firm would need to conduct additional analysis, including a review of the criteria that our framework suggests, in order to determine whether such securities meet the LRM Requirement. Guidance of this nature would allow banks and supervisors to focus attention on a more limited pool of securities where there is a legitimate question as to whether the security in fact has the requisite liquidity profile to be eligible HQLA, ensuring that banks’ and supervisors’ resources are expended in the most beneficial and effective manner.

#### a. Overview of LRM Requirement Implementation Challenges

Under the LCR rule, securities other than those issued or unconditionally guaranteed by the U.S. Department of the Treasury must meet the LRM Requirement in order to be eligible HQLA. To demonstrate that a security is LRM, a banking organization must show that each such “security is traded in an active secondary market with: (1) more than two committed market makers; (2) a large number of non-market maker participants on both the buying and selling sides of transactions; (3) timely and observable market prices; and (4) a high trading volume.” In the process of implementing the LRM Requirement, banks subject to the LCR rule have encountered a number of difficulties that we believe could be substantially mitigated by using the TCH LRM Guidance, including:

- For some elements of the LRM Requirement, there is little or no readily available data to the industry or within banks. As a result, collecting or deriving data to demonstrate that a security is LRM can be a time-intensive manual process with a variation in the quality and quantity of data across securities and banks. For example:
  - There is no central, reliable source for the number of committed market makers nor is there a clear, recognized distinction in the industry **between**

committed market makers and non-committed market makers. Similarly, there is no straightforward methodology for assessing the number of non-market maker participants on both sides of a transaction;

- There is no **established** baseline against which trading volume can be measured to determine whether the **trading** volume should be considered “high”; and
  - In some cases, publicly available data that is used to support an LRM analysis is not available at a granular individual security level.
- Given the broad nature of banks’ operations, the number of individual securities requiring evaluation can be substantial. Even assuming that the data challenges can be overcome, the technical process of linking dynamic market data to other reference data relating to a security (such as a CUSIP, issuer classification, risk weighting, etc.) requires significant time and expense to implement, and, at least for classes of securities that we do not believe pose a real question as to whether they are liquid and readily marketable, the costs of implementation would outweigh the benefits.

These consequences are compounded by the fact that the LRM Requirement would not only apply to unencumbered bank-owned assets included in the numerator of a bank’s LCR, but is also a required component of calculating outflows for the denominator.

We recognize that some of these issues could be mitigated by simply reducing the number or variety of securities that a given banking organization seeks to include as HQLA, as suggested by the Agencies.<sup>109</sup> Such an approach, however, would unnecessarily limit the available pool of eligible HQLA, resulting in further concentrations of holdings in key securities and potentially disrupting demand for other securities.

#### **b. Proposed Asset Classes That Presumptively Meet the LRM Requirement**

The key element of the TCH LRM Guidance is the development of a framework for analyzing categories of securities included in HQLA to determine which securities presumptively should be treated as LRM. An objective framework like the TCH LRM Guidance alleviates the need to undertake and document analysis of the liquidity of asset classes where there is no real question as to whether they have the liquidity profile to be LRM. Under the TCH LRM Guidance, the below asset classes would be presumed to be liquid and readily marketable because they meet the criteria of this framework:

- U.S. GSE pass-through securities;

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<sup>109</sup> 79 Fed. Reg. 61,440 at 61,452.



- U.S. GSE unsecured debt obligations;
- GNMA pass-through securities;
- GNMA and U.S. GSE CMO securities forming part of sequential pay, Planned Amortization Class 1 (PAC 1) or Target Amortization Class 1 (TAC (1) tranches/structures and CMO floaters (excluding inverse floaters));
- Guaranteed securities issued by the following sovereigns:
  - Belgium, Canada, France, Germany, Italy, Japan, Netherlands, United Kingdom, Spain and Australia;
- All securities issued and guaranteed by sovereigns assigned a risk weight between 0 percent and 50 percent under the Agencies' risk-based capital rules, but subject to all of the following conditions:
  - the firm seeking to include the securities has licenses to conduct banking or capital markets operations in the jurisdiction of the sovereign issuer;
  - the securities are issued by the sovereign entity in its own currency and are held by the firm locally to cover local currency cash outflows in periods of stress;
  - the securities qualify as HQLA in the local jurisdiction (under the final LCR rule classification requirements);
  - the sovereign long-term debt rating for the sovereign entity has been investment grade for at least the past five years; and
  - the sovereign has not defaulted or restructured any debt in the last 10 years;
- Debt denominated in USD, EUR, GBP, or JPY issued by the select group of multilateral development bank entities identified in the LCR rule; and
- Publicly traded equity shares that are:
  - included in Russell 1000 index or equivalent index in a non-U.S. jurisdiction; or
  - traded on a recognized national securities exchange, equivalent non-U.S. securities exchange or they form part of a major stock index in the issuer's jurisdiction or a third country, as identified by the issuer or the relevant public authority in a third country. In the absence of any decision from the issuer or

public authority in relation to major stock indices, a stock index composed of leading companies in the relevant jurisdiction shall be considered as a major stock index.

**c. Proposed TCH LRM Requirement Presumption Approach**

The TCH LRM Guidance provides a framework for determining whether classes of securities that meet the other HQLA eligibility criteria under Section 20 of the LCR rule are presumptively LRM based on the liquidity characteristics such securities exhibit on a class-wide basis. Our approach to classifying securities is aligned with the approach outlined in the *Guidance for Supervisors on Market-Based Indicators of Liquidity* (January 2014) issued by the Basel Committee (the “Basel Liquidity Guidelines”). Similar to the Basel Liquidity Guidelines (Table 3), the TCH LRM Guidance incorporates a “tiered checklist approach” that starts with a set of three primary liquidity metrics, which are simple but critical liquidity criteria, and incorporates other liquidity indicia, which are additional liquidity indicators that are designed to be objective and provide a relatively straightforward means of meeting the LRM Requirement presumption.

Each asset class described above, for example, is rated by a Nationally Recognized Statistical Rating Organization, is denominated in a convertible currency, and has pricing information that is publicly available. In addition, securities from these asset classes meet at least some of the following additional criteria: they may be accepted as collateral at Financial Market Infrastructures and/or with private counterparties, they may be eligible for repo or other forward financing, and they may have related hedging markets. Therefore, under the TCH LRM Guidance, the asset classes described above should be presumed liquid and readily marketable.

The list of asset classes above presumptively meeting the LRM Requirement will be reviewed by the industry on an annual basis, or on an as-needed basis, to ensure the presumptions remain valid. Firms may reach a determination of whether additional asset classes meet the LRM Requirement using the approach identified above after consulting with their regulatory supervisor.

Asset classes not conforming to this approach would not presumptively be considered liquid and readily marketable, and therefore banks would need to demonstrate compliance with the LRM Requirement as specified in the LCR rule. Such classes of securities would include, in our view, securities issued by U.S. agencies such as the Small Business Administration, Department of Veterans Affairs, the National Credit Union Administration, the Federal Deposit Insurance Corporation’s structured sale of guaranteed notes (SSGN), and GNMA and U.S. GSE CMO securities forming part of one or more of inverse floater and Z tranches.

**2. The Agencies' proposed modifications to the definitions of secured lending transaction and secured funding transaction pose several issues that should be corrected in advance of finalization of the NSFR.**

Under the proposed rule, the definition of a “secured lending transaction” is limited to transactions with wholesale customers and counterparties. This definition should be expanded to include transactions with retail customers, and in particular open maturity securities-based loans that many U.S. banking organizations provide to their retail customers. In a typical structure, retail customers own LRM debt or equity securities through brokerage accounts with a broker-dealer affiliate of the banking organization, and the banking organization may be willing to extend loans to the customer collateralized by the value of such securities in the customer’s brokerage account. The Associations therefore respectfully request that the Agencies extend the definition of “secured lending transactions” to include a specific category of loan products that have the following characteristics: (i) the loans are made to retail customers, (ii) securities fully collateralize the customer loan and the banking organization marks-to-market these securities on a daily basis, (iii) the loans have no express maturity date, (iv) with a notice period of less than 30 days (oftentimes one day), either the customer can terminate the loan through repayment or the banking organization can demand repayment in full of all outstanding obligations, and (v) if the customer fails to meet a repayment obligation, the banking organization can close out the loan and liquidate securities to cover the loan amount.

From an economic perspective, open maturity securities-based loans are secured lending transactions analogous to open maturity reverse repurchase agreements with wholesale counterparties. In each case, the lender of cash enters the transaction fully secured by counterparty collateral, and the lender has the legal right and operational ability to close out and sell collateral to offset credit exposure if the counterparty defaults on its payment obligations. More fundamentally, in both open maturity securities-based loans and reverse repurchase agreements, the defining characteristic of the transaction is the fact that it is secured; the lender would be unwilling to extend credit under the same terms and conditions in the absence of daily mark-to-market collateralization. In addition, when reverse repurchase agreements have open maturities, they are similar to open maturity retail customer securities-based loans in that the maturity extends each day in the absence of a termination notice, since the cash-providing party is fully secured against the possibility of default of the counterparty. Accordingly, open maturity retail customer securities-based loans are more like secured lending transactions than retail transactions, from an economic perspective. In light of the economic similarity of these transactions from the perspective of the funding banking organization, these transactions with retail customers should be afforded similar treatment under the NSFR. We therefore request that the Agencies include retail customer securities-based loans within the definition of secured lending transactions applicable for purposes of both the NSFR and the LCR.

In addition, the Agencies propose to modify the definitions of “secured funding transaction” and “secured lending transaction,” respectively, to limit the types of assets that qualify as “security” from “secured by a lien on other assets” to “secured by a lien on securities

or loans.”<sup>110</sup> Although the Agencies presumably intended to limit the definitions to assets that are liquid and tradable (that is, assets other than fixed assets), the use of the term “securities” can be read narrowly to limit the types of assets that may be included. As a conceptual matter, this definitional change would effectively exclude short-term debt, commercial paper, gold and other assets that effectively reduce the risk associated with secured transactions by inappropriately circumscribing the universe of LRM assets recognized under the proposed rule and the LCR rule merely because these assets may not be considered “securities” as a definitional matter under relevant U.S. securities law. To address these concerns and any concern on the part of the Agencies with respect to a banking organization’s ability to sell an “asset” by which these transactions are secured, we suggest that the Agencies include a similarly tailored definition, such as “financial asset,” so as to more appropriately capture the types of assets that should be recognized under the respective definitions.

**3. The revised definitions of “unsecured wholesale funding” and “unsecured wholesale lending” should not be deemed to capture asset exchanges.**

The Proposed Rule would define “unsecured wholesale funding” as a liability or general obligation of a Covered Company to a wholesale customer or counterparty that is “not a secured funding transaction.”<sup>111</sup> By contrast, the definition currently applicable under the LCR rule describes an unsecured wholesale funding transaction as “... a liability or general obligation ... that is not *secured under applicable law*.”<sup>112</sup> Although “asset exchange” is currently separately defined in the LCR rule, an asset exchange could be viewed as a liability or general obligation that is not a secured funding transaction if entered into with a wholesale customer or counterparty and therefore possibly treated as “unsecured wholesale funding” under these definitional changes introduced by the Proposed Rule. The same is true with respect to the definition of “unsecured wholesale lending.” We do not believe that the proposed definitional adjustments specified in the proposed rule are meant to apply to transactions such as asset exchanges that are not intended to be captured under the unsecured wholesale funding framework.

**B. The Agencies’ Pillar 3 market discipline-related policy objectives would be better achieved by a more limited form of quantitative disclosure of NSFR information and providing Covered Companies with additional time to prepare for implementation of the proposed rule’s disclosure requirements.**

The NSFR disclosure template included in the proposed rule would provide relatively specific information about a banking organization’s funding and related business strategies at a time when the operational effects of the proposed rule would not yet have been fully appreciated

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<sup>110</sup> See NSFR Proposed Rules, at 35,130.

<sup>111</sup> Proposed Rule, § 249.3, at 35177.

<sup>112</sup> 12 C.F.R. § 249.3.

by the industry, the markets in which they operate or even the Agencies themselves. We are concerned that this level of disclosure could constrain banking organizations' ability to execute those strategies. A banking organization may be inhibited from adjusting its funding strategy if such action would be viewed by market participants as a material divergence from the funding strategies of peer firms, effectively forcing all firms to maintain similar composition even where their respective funding needs differ in practice. While it is true that the clarifying explanations of information provided in the quantitative disclosure template could be explained in the qualitative disclosure section required under both the proposed rule and the Basel NSFR disclosure requirement, we are nevertheless concerned that, particularly for purposes of making peer-to-peer comparisons among subject firms, the required quantitative information—rather than the qualitative description—will be the primary focus of market users of NSFR disclosures.

Furthermore, the implementation timeline outlined in the proposed rule does not allow banking organizations adequate time to prepare data collection processes aligned with the disclosure requirements of the proposed rule once finalized. To avoid operational issues—particularly until the impacts of compliance with the NSFR are better understood—we believe that the Agencies' Pillar 3 market discipline-related policy objectives would be better achieved by limiting quantitative disclosure of NSFR information and providing Covered Companies with additional time to prepare data collection processes to improve the alignment of such processes with the proposed public reporting requirements. With respect to the granularity of NSFR disclosure, the Associations believe that NSFR disclosures should be limited to the information required to be disclosed by banking organizations under the Basel NSFR disclosure template.<sup>113</sup> The information called for by the Basel NSFR disclosure template would provide market participants with the information necessary to serve the purposes of Pillar 3 reporting—that is, to monitor the funding position of the consolidated banking organization. Furthermore, additional time will be necessary once the final rule is published for Covered Companies to map the final public disclosure requirements to the relevant reporting processes. We therefore urge the Agencies to time implementation of the NSFR disclosure requirements under the proposed rule such that banking organizations are afforded a minimum of two years after publication of the final rule to prepare systems and processes for data collection, with actual data collection pursuant to the public disclosure requirements to begin on the first day of the financial reporting period beginning not earlier than two years following publication of the final rule in the Federal Register.

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The Associations appreciate the opportunity to comment on the proposal. If the Agencies would like additional information regarding these comments, please contact Brett Waxman at (212) 612-9211 ([brett.waxman@theclearinghouse.org](mailto:brett.waxman@theclearinghouse.org)), Carter McDowell at (202) 962-7327 ([cmcdowell@sifma.org](mailto:cmcdowell@sifma.org)), Richard Foster at (202) 589-2424 ([richard.foster@fsroundtable.org](mailto:richard.foster@fsroundtable.org)),

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<sup>113</sup> See Basel Committee, *Net Stable Funding Ratio Disclosure Standards* (June 2015), available at: <http://www.bis.org/bcbs/publ/d324.pdf>.

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Respectfully submitted,



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Board of Governors of the Federal  
Reserve System  
Office of the Comptroller of the Currency  
Federal Deposit Insurance Corporation

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August 5, 2016

Richard Coffman  
General Counsel  
*Institute of International Bankers*

A handwritten signature in blue ink, appearing to read "M. Flood", with a long horizontal flourish extending to the right.

Michael Flood  
Deputy Executive Director  
*CRE Finance Council*

cc: Scott Alvarez  
Michael Gibson  
Adam S. Trost  
(Board of Governors of Federal Reserve System)

Bobby R. Bean  
Doreen Eberly  
Eric W. Schatten  
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*The Clearing House.* The Clearing House is a banking association and payments company that is owned by the largest commercial banks and dates back to 1853. The Clearing House Association L.L.C is a nonpartisan organization that engages in research, analysis, advocacy and litigation focused on financial regulation that supports a safe, sound and competitive banking system. Its affiliate, The Clearing House Payments Company L.L.C., owns and operates core payments system infrastructure in the United States and is currently working to modernize that infrastructure by building a new, ubiquitous, real-time payment system. The Payments Company is the only private-sector ACH and wire operator in the United States, clearing and settling nearly \$2 trillion in U.S. dollar payments each day, representing half of all commercial ACH and wire volume.

*The Securities Industry & Financial Markets Association.* SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over \$2.5 trillion for businesses and municipalities in the U.S., serving clients with over \$20 trillion in assets and managing more than \$67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit <http://www.sifma.org>.

*The Financial Services Roundtable.* As advocates for a strong financial future™, FSR represents 100 integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. FSR member companies provide fuel for America's economic engine, accounting directly for \$98.4 trillion in managed assets, \$1.1 trillion in revenue, and 2.4 million jobs.

*The American Bankers Association.* The American Bankers Association is the voice of the nation's \$16 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard \$12 trillion in deposits and extend more than \$8 trillion in loans.

*The Institute of International Bankers.* IIB is the only national association devoted exclusively to representing and advancing the interests of the international banking community in the United States. Its membership is comprised of internationally headquartered banking and financial institutions from over 35 countries around the world doing business in the United States. The IIB's mission is to help resolve the many special legislative, regulatory, tax and compliance issues confronting internationally headquartered institutions that engage in banking, securities and other financial activities in the United States. Through its advocacy efforts the IIB seeks results that are consistent with the U.S. policy of national treatment and appropriately limit the extraterritorial application of U.S. laws to the global operations of its member institutions. Further information is available at [www.iib.org](http://www.iib.org).

*The CRE Finance Council.* The CRE Finance Council (CREFC) is the collective voice of the more than \$3.5 trillion commercial real estate finance market, and our members include all of the significant portfolio, multifamily, and commercial mortgage-backed securities lenders and issuers; loan and bond investors such as insurance companies, pension funds and money

managers; servicers; rating agencies; accounting firms; law firms; and other service providers. CREFC's membership consists of more than 300 companies and 8,000 individuals. Our industry plays a critical role in the financing of office buildings, industrial complexes, multifamily housing, retail facilities, hotels, and other types of commercial real estate that help form the backbone of the American economy. In addition to its sector specific member forums, committees and working groups, CREFC acts as a legislative and regulatory advocate for the industry, plays a vital role in setting market standards and provides education for market participants in this key sector of the global economy. For more information visit [www.crefc.org](http://www.crefc.org).

Annex B

Recognition of the Funding Value of Variation Margin Received in the Form of Level 1 Securities

<b>Scenario 1:</b> (Current Proposed)	MtM gain of \$50 with Counterparty A. As a result, the Bank receives \$50 in daily cash VM
	MtM Loss of \$50 with Counterparty B. As a result, the Bank posts \$50 in daily cash VM
	Net PnL and Shareholders' equity is flat
	The Bank also holds US Treasuries unencumbered \$100

	GAAP Balance Sheet	GAAP \$	NSFR			
			Gross NSFR \$	RSF / ASF %	RSF / ASF \$	
Receive & post daily VM in Cash	<b>ASSETS</b>					
	Cash	100.0	100.0	0%	-	
	Long Treasuries (unencumbered)	100.0	100.0	5%	5.0	
	Long Treasuries (encumbered)	-	-	100%	-	
	Derivative MtM receivable from CP-A	50.0				
	Cash collateral posted to CP-B	50.0				
	Cash collateral netting (FIN 39)	(100.0)				
	Net Derivative assets	-				
	Net NSFR Derivative Assets			-	100%	-
	20% of Gross Derivative Liabilities			50.0	20%	10.0
	<b>Total GAAP Assets / RSF</b>		<b>200.0</b>			<b>15.0</b>
	<b>LIABILITIES</b>					
	Derivative MtM payable to CP-B	50.0				
	Cash collateral received from CP-A	50.0				
	Cash collateral netting (FIN 39)	(100.0)				
	Net Derivative Liability	-				
	Unsecured short term funding	185.0		185.0	0%	-
	<b>Shareholders Equity</b>		<b>15.0</b>			<b>15.0</b>
	<b>Total GAAP Equities &amp; Liabilities / ASF</b>		<b>200.0</b>			<b>15.0</b>
				<b>NSFR (excess / (deficit) \$</b>		<b>-</b>
			<b>NSFR ratio %</b>		<b>100%</b>	

<b>Scenario 2:</b> (Current Proposed)	MtM gain of \$50 with Counterparty A. As a result, the Bank receives \$50 in daily cash VM
	MtM Loss of \$50 with Counterparty B. As a result, the Bank posts \$50 in U.S. Treasury Security VM
	Net PnL and Shareholders' equity is flat
	The Bank also holds US Treasuries unencumbered \$50, and encumbered \$50 used for VM posting

	GAAP Balance Sheet	GAAP \$	NSFR			
			Gross NSFR \$	RSF / ASF %	RSF / ASF \$	
Receive daily VM in Cash & post UST security	<b>ASSETS</b>					
	Cash	150.0	150.0	0%	-	
	Long Treasuries (unencumbered)	50.0	50.0	5%	2.5	
	Long Treasuries (encumbered)	50.0	50.0	5%	2.5	
	Derivative MtM receivable from CP-A	50.0				
	Cash collateral posted to CP-B	-				
	Cash collateral netting (FIN 39)	(50.0)				
	Net Derivative assets	-				
	Net NSFR Derivative Assets			-	100%	-
	20% of Gross Derivative Liabilities			50.0	20%	10.0
	<b>Total GAAP Assets / RSF</b>		<b>250.0</b>			<b>15.0</b>
	<b>LIABILITIES</b>					
	Derivative MtM payable to CP-B	50.0				
	Cash collateral received from CP-A	50.0				
	Cash collateral netting (FIN 39)	(50.0)				
	Net Derivative Liability	50.0				
	Unsecured short term funding	185.0		185.0	0%	-
	<b>Shareholders Equity</b>		<b>15.0</b>			<b>15.0</b>
	<b>Total GAAP Equities &amp; Liabilities / ASF</b>		<b>250.0</b>			<b>15.0</b>
				<b>NSFR (excess / (deficit) \$</b>		<b>-</b>
			<b>NSFR ratio %</b>		<b>100%</b>	

**Scenario 3:** MtM gain of \$50 with Counterparty A. As a result, the Bank receives \$50 in U.S. Treasury Security VM  
**(Current Proposed)** MtM Loss of \$50 with Counterparty B. As a result, the Bank posts \$50 in daily cash VM  
 Net PnL and Shareholders' equity is flat  
 The Bank also holds US Treasuries unencumbered \$100

	GAAP Balance Sheet	GAAP \$	NSFR		
			Gross NSFR \$	RSF / ASF %	RSF / ASF \$
Receive UST security & post daily VM in Cash	<b>ASSETS</b>				
	Cash	50.0	50.0	0%	-
	Long Treasuries (unencumbered)	100.0	100.0	5%	5.0
	Long Treasuries (encumbered)	-	-	-	-
	Derivative MtM receivable from CP-A	50.0			
	Cash collateral posted to CP-B	50.0			
	Cash collateral netting (FIN 39)	(50.0)			
	Net Derivative assets	50.0			
	Net NSFR Derivative Assets		50.0	100%	50.0
	Treasuries received as collateral				
	20% of Gross Derivative Liabilities		50.0	20%	10.0
	<b>Total GAAP Assets / RSF</b>	<b>200.0</b>			<b>65.0</b>
	<b>LIABILITIES</b>				
	Derivative MtM payable to CP-B	50.0			
	Cash collateral received from CP-A	-			
Cash collateral netting (FIN 39)	(50.0)				
Net Derivative Liability	-				
Unsecured short term funding	185.0	185.0	0%	-	
Shareholders Equity	15.0	15.0	100%	15.0	
<b>Total GAAP Equities &amp; Liabilities / ASF</b>	<b>200.0</b>			<b>15.0</b>	
		<b>NSFR (excess / (deficit) \$</b>		<b>(50.0)</b>	
		<b>NSFR ratio %</b>		<b>23%</b>	

**Recommended Treatment** Recognize the value of security variation margin received  
 U.S. Treasury security received from Counterparty A should be allowed to net against the derivative MtM receivable, as it's no different than a reverse repo asset or a firm long asset when they are used as sources of collateral posted to, or netted against derivative payables.

	GAAP Balance Sheet	GAAP \$	NSFR		
			Gross NSFR \$	RSF / ASF %	RSF / ASF \$
Receive UST security & post daily VM in Cash	<b>ASSETS</b>				
	Cash	50.0	50.0	0%	-
	Long Treasuries (unencumbered)	100.0	100.0	5%	5.0
	Long Treasuries (encumbered)	-	-	-	-
	Derivative MtM receivable from CP-A	50.0			
	Cash collateral posted to CP-B	50.0			
	Cash collateral netting (FIN 39)	(50.0)			
	Net Derivative assets	50.0			
	NSFR Derivative Assets (pre-securities netting)		50.0	100%	50.0
	Treasuries received as collateral				(50.0)
	20% of Gross Derivative Liabilities		50.0	20%	10.0
	<b>Total GAAP Assets / RSF</b>	<b>200.0</b>			<b>15.0</b>
	<b>LIABILITIES</b>				
	Derivative MtM payable to CP-B	50.0			
	Cash collateral received from CP-A	-			
Cash collateral netting (FIN 39)	(50.0)				
Net Derivative Liability	-				
Unsecured short term funding	185.0	185.0	0%	-	
Shareholders Equity	15.0	15.0	100%	15.0	
<b>Total GAAP Equities &amp; Liabilities / ASF</b>	<b>200.0</b>			<b>15.0</b>	
		<b>NSFR (excess / (deficit) \$</b>		<b>-</b>	
		<b>NSFR ratio %</b>		<b>100%</b>	

**Scenario 4:** MtM gain of \$50 with Counterparty A. As a result, the Bank receives \$50 in U.S. Treasury Security VM  
**(Current Proposed)** MtM Loss of \$50 with Counterparty B. As a result, the Bank posts \$50 in U.S. Treasury Security VM  
 Net PnL and Shareholders' equity is flat  
 The Bank also holds US Treasuries unencumbered \$50, and encumbered \$50 used for VM posting

	GAAP Balance Sheet	GAAP \$	NSFR		
			Gross NSFR \$	RSF / ASF %	RSF / ASF \$
Receive & post UST security	<b>ASSETS</b>				
	Cash	100.0	100.0	0%	-
	Long Treasuries (unencumbered)	50.0	50.0	5%	2.5
	Long Treasuries (encumbered)	50.0	50.0	5%	2.5
	Derivative MtM receivable from CP-A	50.0			
	Cash collateral posted to CP-B	-			
	Cash collateral netting (FIN 39)	-			
	Net Derivative assets	50.0			
	Net NSFR Derivative Assets		50.0	100%	50.0
	Treasuries received as collateral				
	20% of Gross Derivative Liabilities		50.0	20%	10.0
	<b>Total GAAP Assets / RSF</b>	<b>250.0</b>			<b>65.0</b>
	<b>LIABILITIES</b>				
	Derivative MtM payable to CP-B	50.0			
	Cash collateral received from CP-A	-			
Cash collateral netting (FIN 39)	-				
Net Derivative Liability	50.0				
Unsecured short term funding	185.0	185.0	0%	-	
Shareholders Equity	15.0	15.0	100%	15.0	
<b>Total GAAP Equities &amp; Liabilities / ASF</b>	<b>250.0</b>			<b>15.0</b>	
		<b>NSFR (excess / (deficit) \$</b>		<b>(50.0)</b>	
		<b>NSFR ratio %</b>		<b>23%</b>	

**Recommended Treatment** Recognize the value of security variation margin received  
 U.S. Treasury security received from Counterparty A should be allowed to net against the derivative MtM receivable, as it's no different than a reverse repo asset or a firm long asset when they are used as sources of collateral posted to, or netted against derivative payables.

	GAAP Balance Sheet	GAAP \$	NSFR		
			Gross NSFR \$	RSF / ASF %	RSF / ASF \$
Receive & post UST security	<b>ASSETS</b>				
	Cash	100.0	100.0	0%	-
	Long Treasuries (unencumbered)	50.0	50.0	5%	2.5
	Long Treasuries (encumbered)	50.0	50.0	5%	2.5
	Derivative MtM receivable from CP-A	50.0			
	Cash collateral posted to CP-B	-			
	Cash collateral netting (FIN 39)	-			
	Net Derivative assets	50.0			
	NSFR Derivative Assets (pre-securities netting)		50.0	100%	50.0
	Treasuries received as collateral				(50.0)
	20% of Gross Derivative Liabilities		50.0	20%	10.0
	<b>Total GAAP Assets / RSF</b>	<b>250.0</b>			<b>15.0</b>
	<b>LIABILITIES</b>				
	Derivative MtM payable to CP-B	50.0			
	Cash collateral received from CP-A	-			
Cash collateral netting (FIN 39)	-				
Net Derivative Liability	50.0				
Unsecured short term funding	185.0	185.0	0%	-	
Shareholders Equity	15.0	15.0	100%	15.0	
<b>Total GAAP Equities &amp; Liabilities / ASF</b>	<b>250.0</b>			<b>15.0</b>	
		<b>NSFR (excess / (deficit) \$</b>		<b>-</b>	
		<b>NSFR ratio %</b>		<b>100%</b>	