Deutsches Aktieninstitut

Impact of the Net Stable Funding Ratio on Prices and Availability of Derivatives Used for Hedging Purposes by Non-Financial Companies Needs Careful Evaluation

Response of Deutsches Aktieninstitut to the DG FISMA Consultation Paper on Further Consideration for the Implementation of the Net Stable Funding Ratio (NSFR) in the EU, 23 June 2016

General Remarks

This position paper briefly summarizes the comments of German non-financial companies on the consultation paper on the implementation of the NSFR. Our view is based on discussions in the corporate finance/corporate treasury working group of Deutsches Aktieninstitut which is the central forum of opinion building for the treasury departments of the biggest German non-financial companies.

Non-financial companies have generally been supportive to the strengthening of bank and capital market regulation in the aftermath of the crisis because systemic stability in general and safe and sound banks are key for the allocation of capital and thus growth of the entire economy. In this context we understand the NSFR as a supplementary measure to prevent medium-term illiquidity and funding risks of banks which we basically support.

However, we also believe that the regulation of banks – if too strict – may finally interfere with the banks' role as intermediaries and risk takers for the economy. Indeed, we have always pointed to the fact that there may be a trade-off between the risk limiting effects of regulation on the one hand and negative side effects on the role of banks for the economy and for users of financial services on the other.

Against this background we would like to encourage you to analyze in depth the treatment of derivatives in the NSFR. Derivatives play a crucial role for non-financial companies as they are used to hedge risks resulting from their operative businesses. The use of derivatives, thus, stabilizes income flows and – ultimately – the long-term creditworthiness of non-financial companies.

It has therefore been widely acknowledged by regulators that regulation should not constrain the use of derivatives by non-financial companies. Accordingly, the regulator has rightly introduced some elements in the EU Derivative Regulation EMIR, the MiFIR/MiFID package and the CRR/CRD IV that acknowledge the specifics of the use of derivatives by non-financial companies in order to avoid negative side effects on business operations.

Our general request is, therefore, that potential negative impacts on the prices and the availability of hedging instruments are carefully evaluated and understood before the NSFR is implemented in Europe. Our comments below thus focus on questions 3, 4 and 5 of the consultation paper.

3. In light of previous consultations, could you provide substantiated evidence about possible issues caused by the application of the BCBS NSFR standard to derivative transactions at European level and which have not been taken into account at Basel level? If yes, what alternative treatment would you propose for NSFR calculation purposes to deal with the funding needs arising from derivatives transactions? If possible, please provide the impact on your institution of the alternative treatment you propose (as compared to the BCBS standards).

4. More specifically, regarding the 20% RSF factor applicable to gross derivatives liabilities, do you think it would be possible and appropriate to develop a more risk-sensitive approach that would take better account of the funding risk arising from banks' derivative activities over a one-year horizon? In that case, what could be this approach? Do you think that the use of the SA-CRR could provide an appropriate measure? If possible, please provide the impact on your institution of the alternative treatment you propose (as compared to the BCBS standards).

We do not fully understand the rationale for the 20% RSF-factor for gross derivative liabilities. At least without further evidence and explanations provided a bank's gross derivative liabilities appear to be an inappropriate indicator of its market contingent funding requirements as these cannot be evaluated without simultaneously regarding derivative assets. In the same way, the RSF factor takes into account neither (i) the collateral the bank is required to post to secure its derivative liabilities nor (ii) the rehypothecable cash and liquid securities a bank receives from other counterparties to secure its derivative assets.

In addition to that, there are some specifics with derivative positions banks have vis-à-vis non-financial counterparties that use derivatives for hedging purposes that make the justification of the RSF-factor even more disputable in case of derivatives with non-financial companies. Most importantly, those hedges are regularly conducted on an uncollateralized basis. EBA, however, argues that the 20% factor is supposed to counter a hypothetical risk from a potential future requirement for the bank to post collateral. We would not expect that non-financial companies would be keen to post collateral in future as this would result in significant funding requirements. Quite the opposite is true so that the hypothetical posting of collateral cannot be taken as a reason for additional funding requirements.

In sum, we do not fully understand the rationale of the 20% factor as well as its level and we encourage the EU Commission to evaluate alternatives or even drop this requirement during the implementation process. Otherwise, we are concerned that hedging of the business operation of the non-financial sector may become more costly or the availability of hedging instruments may shrink if banks are not able to refund the relevant positions in the market. If such an effect materialized we would regard it as an inconsistency in the EU financial market regulation that has rightly recognized that the use of derivatives of non-financial companies is generally beneficial for the economy.

5. If you propose special treatment for specific activities (eg hedging instruments, clients clearing…), how would you define these activities?

As pointed out above non-financial counterparties have some special characteristics that need to be appropriately reflected in the regulation. Most importantly, derivative positions of non-financial companies are backed by operative cash flows or assets, such as raw materials used in production or long-term financing. Furthermore, these hedges are usually not collateralized which avoids liquidity risk on the side of the non-financial companies and – ultimately – additional funding from the banking system. Third, derivatives of non-financial companies make up only a small share of the world derivative market. Considering these special characteristics the legislator rightly came to the conclusion that derivatives of non-financial companies do not bear systemic risks and, thus, deserve special treatment in the regulation as is reflected in the clearing exemption of EMIR and the complementing measures in MiFID/MiFIR as well as the CRR/CRD IV.

From our point of view it should be considered to “mirror” these exemptions also in the NSFR in an appropriate technical way.

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