April 11, 2014

Comments on the Basel Committee on Banking Supervision's Consultative Document:
Basel III: The Net Stable Funding Ratio

Japanese Bankers Association

We, the Japanese Bankers Association, would like to express our gratitude for this opportunity to comment on the consultative document: *Basel III: The Net Stable Funding Ratio*, released on January 12, 2014 by the Basel Committee on Banking Supervision (the "BCBS").

We hope that our comments below will be of assistance and offer an additional point of reference as you work towards finalising the framework.

General comments

- **NSFR should be appropriately designed so as not to undermine the functioning of essential products and markets for the economy.**

  While the proposed NSFR is designed based on multiple assumptions, thorough consideration should be given to ensure an appropriate balance in assigning ASF and RSF factors so as not to undermine the functioning of products and funding markets which are essential for the economy.

  We understand from the Consultative Document that the BCBS reviewed the NSFR to establish a more general ratio measuring a structural balance of banks' assets and liabilities, which does not assume specific stress conditions. Although there are some explanations on grounds for ASF and RSF factors, the Consultative Document only provides several abstract underlying criteria for the assignment of factors (Paragraphs 12 and 13). For instance, it is presumed that factors are designed on business-as-usual basis from one of the criteria set out in Paragraph 13(b) ("banks may seek to roll over a significant proportion of maturing loans to preserve customer relationship"). On the other hand, there are some RSF factors which are assigned in a conservative manner assuming severe stress conditions. It is not specified to what extent such criteria were taken into account in assigning each ASF/RSF factor.

  As discussed in the "Specific Comments" section below, there are some cases where specific criteria/assumptions appear to be reflected in the ASF/RSF assignment more than the reality, as well as the cases where ASF and RSF factors for certain transactions are asymmetrical. We respectfully request that the BCBS will continue thorough discussions and open dialogue with industry so that NSFR will become an appropriate incentive for banks' operations and contribute to the financial system stability.

Specific Comments

- **Loans to central banks with residual maturity of less than six months should be assigned a 0% RSF factor (Paragraph 22 (a), Paragraph 32(e)).**

  NSFR should not include a factor which may disincentivise banks to respond to central banks' specific monetary control measures[1]. Under the Consultative Document, if the central bank executes fund absorption operations through repo transactions (i.e. from the bank's perspective, reverse repos executed with the central bank), such transactions are deemed as loans to the central bank and are assigned a 50% RSF factor. A 0% RSF factor should apply instead so as not to reduce banks' incentive to respond to the central banks' operations using repos, repurchase agreements or resale agreements.

- **Deposits from central banks in other jurisdictions with residual maturities of less than one year (excluding central bank operations) should be assigned a 50% ASF factor, in-line with funding from sovereigns and public sector entities (Paragraph 21 (c)).**

  Under the LCR, the outflow rate applied to deposits from central banks is the same as the one applied to deposits from sovereigns and public sector entities (the highest outflow rate is 40%). Applying a 0% ASF factor to deposits from central banks with residual maturity of less than six months under the NSFR is considered overly conservative in relation to the LCR, which does not assume a 100% outflow even in its severe stress period.

  If the proposed ASF is the result of taking the neutrality with central banks' monetary operations into account, a 50% ASF factor, that is applied to the funding from sovereigns and public sector entities, should also be applied to the funding from central banks which is deemed as unrelated to the fund supply operations[2]. Similarly to deposits from non-financial corporations, it is difficult for banks to control deposits from central banks, and hence banks would not rely on deposits from central banks intentionally.

- **The treatment of money market instruments issued by banks (e.g. CDs) with residual maturities of less than six months should be reconsidered (Paragraph 29(c), Paragraph 32(e)).**

  Money market instruments, including CDs, are conceived to be assigned a 50% RSF factor in line with Paragraph 32 (e). On the other hand, loans to banks with residual maturities of less than six months are assigned a 0% RSF factor in accordance with Paragraph 29(c).

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[1] There are multiple monetary control measures, including: (i) reserve rate adjustments in central bank reserve requirements; (ii) operations through secured loans backed by government bonds, etc. (repos) and resale/repurchase agreements; and (iii) operations through selling/buying securities (government bonds, central bank bills, etc.). Furthermore, specific measures differ across jurisdictions.

[2] For example, this may include deposits denominated in currencies other than the local currency of the central bank (i.e. foreign-currency denominated central bank reserve).

Since the holding of money market instruments issued by banks can be deemed equivalent to loans to banks in terms of economic substance, they should also be assigned a 0% RSF factor.

- **Rationales for the proposed RSF factors for liquid assets, especially those with residual maturities of less than one year, should be provided (Paragraph 30).**
  In light of avoiding overlapping management of liquid assets, it is considered reasonable to a certain extent to maintain consistency in the classification of liquid assets with that of the LCR. However, the underlying idea in assigning the similar factors is uncertain; LCR haircuts are based on simulation of cash inflow/outflow under 1-month stressed conditions driven by multiple factors, but the NSFR is intended to ensure the stability over a longer time horizon (1 year).
  Furthermore, while Level 1 assets are recognised as highly liquid in the LCR (that is, Level 1 assets are not subject to a haircut for inclusion in the high quality liquid assets (HQLA)), they are all assigned a 5% RSF factor in the NSFR. It is not clear why the NSFR framework requires required stable funding for HQLA which are necessary to be held under the LCR framework. (A 5% RSF factor may be quite high for Level 1 assets with residual maturities of less than one year, if such 5% rate is for default rate.)
  With regard to the holding of liquid assets, there is already a concern among banks that different incentives may arise between the LCR and the leverage ratio frameworks, both of which are the indicators to be introduced as part of the Basel III regime. Creating a different incentive in addition within the liquidity framework may impose unnecessary difficulties on bank’s liquidity management.

- **A 0% RSF factor should be applied to deferred and accrued accounts (e.g. accounts receivables arising from trade date accounting of securities, etc. and accrued interest on loans), especially to those assets that will be settled within one year (Paragraph 32(e), 35(c)).**
  Out of the assets categorized under “other assets” by Paragraph 32(e) or 35(c), those assets that arise from financial transactions for accounting purposes, and are to be derecognised in a short period of time should be assigned a 0% RSF factor, because funding is virtually unnecessary for such assets.
  The assets that arise from financial transactions and are recognised for accounting purposes include accounts receivable from the sale of bonds, including government bonds, and accrued interest on loans. According to the Consultative Document, either a 50% or 100% RSF factor is applied to such assets. However, the proposed factors are not appropriate because additional funding needs for such deferred and accrued accounts would not be assumed in any case.

Additionally, it is not equitable to apply only an RSF factor to payables/receivables recognised simultaneously in a cross-trade of bonds, and to recognise accounting items (liability or asset) differently depending on the payment methods for interest on loans (payment in advance or in arrear).

Such assets recognised for accounting purposes not only include assets being recorded for a short-term (e.g. receivables/payables related to the sales and purchase of bonds), but also include accrued interest on loans where interest payments are made periodically, for instance, on an annual basis (every 12 months). Therefore, a 0% RSF factor should be applied at least to those assets whose scheduled settlement arrives within one year.

- **The definition of the term "small- and medium-sized entities (SMEs)" should be consistent with the definition used in the LCR framework (Paragraph 19, note 6).**

  The Consultative Document stipulates in Footnote 6 of Paragraph 19 that the small- and medium-sized entities (SMEs) are defined in Paragraph 273 of the Basel II framework. On the other hand, the final text of the LCR framework uses the term "Small business customers" and defines it in line with Paragraph 231 of the Basel II framework (BCBS128). The Consultative Document should maintain consistency with the LCR framework in this respect.

  Further, Table 2 (Summary of asset categories and associated RSF factors) in Paragraph 36 uses the different term "small business customers" to express the same business as the above SMEs.

  Since it is considered that there is no necessity in changing the category of business from that in the LCR framework, the expressions, definitions and references in line with Paragraph 90 of the LCR framework text (BCBS238) should be aligned.

- **The definition of the term "banks subject to prudential supervision" should be clarified, and should include securities and insurance companies (Paragraph 29(c), Paragraph 32(c)).**

  If the definition of the term "banks subject to prudential supervision" only includes banks, as in the LCR, it may lead to unintended consequences in liquidity market. For example, in the repo market where those other than "banks subject to prudential supervision" consists of a majority of participants, transactions may excessively be concentrated on the banks.

  Securities companies and insurance companies are the main participants of the repo market, and are subject to industry-specific regulations and supervision in each jurisdiction. Given this perspective, it is reasonable to consider including securities and insurance companies in the definition of "subject to prudential supervision."

- **An RSF factor applied to reverse repos settled through CCPs should be reconsidered (Paragraph 29(c)).**

  Based on the idea that transactions settled through CCP is safer than over-the-counter transactions with banks subject to prudential supervision, and taking into consideration the international movement toward centralised clearing, the application of an RSF factor to transactions settled through CCPs should be set of 0% in line with that of loans to banks subject to prudential supervision with a residual maturity of less than six months. The BCBS is requested to clarify that transactions settled through CCPs are included in the scope of Paragraph 29 (c).