Meeting between Staff of the Federal Reserve Board and Credit Suisse  
June 7, 2017

Participants: Mark Van Der Weide, Anna Lee Hewko, Peter Clifford, Kevin Littler, Christopher Powell, and Brian Chernoff (Federal Reserve Board)

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Summary: Staff of the Federal Reserve Board met with representatives of Credit Suisse to discuss the notice of proposed rulemaking to establish a Net Stable Funding Ratio (NSFR) requirement. Specifically, Credit Suisse’s representatives discussed the required stable funding factors assigned to equity securities and the required and available stable funding factors assigned to hedges of certain derivatives and short sale-related positions under the proposed rule. Credit Suisse’s representatives also discussed NSFR implementation in Switzerland and the application of an NSFR requirement to intermediate holding companies of foreign banking organizations.

Attachment
Discussion of the Proposed Net Stable Funding Ratio (NSFR) Requirement

Board of Governors of the Federal Reserve System
June 7, 2017
Overall Views

- We want to share our experiences preparing for NSFR implementation in Switzerland with a view to informing the Fed should it decide to proceed with a similar requirement in the U.S.

- We absolutely agree that long-term funding is essential across a range of businesses e.g., equity swaps. But the NSFR may not be the best tool to achieving this goal for a number of reasons:
  - First, the Fed and other regulators have created a robust infrastructure of liquidity-related rules and stress tests that already address the risks that the NSFR is designed to counter. This is particularly true for IHCs that are already subject to rigorous home country requirements.
  - Second, the proposed haircuts under the NSFR do not appropriately reflect the demonstrated performance of equities under both normal and stressed conditions. As such, the NSFR haircuts do not accurately reflect the long-term funding risks faced by institutions.
  - Third, this mispricing of risk, along with other provisions such as the lack of an exemption for interdependent assets and liabilities, has already led those institutions soon to be subject to the requirement withdrawing from key market-making businesses. Were the requirement to be extended across the board to all institutions, we would see meaningful reductions in market liquidity and increased costs for investors.

- Overall then, the NSFR appears to add marginal benefit on top of the existing U.S. liquidity regime, while adding significantly to funding costs for both institutional and (via pension funds and other vehicles) retail investors, ultimately dampening economic growth. This asymmetry between the costs and benefits suggests that it may be worth revisiting the NSFR framework at a fundamental level.
1. Background on Swiss Implementation
Swiss Liquidity Framework Implementation

- FINMA issued a consultation paper for the NSFR framework and revisions to the LCR framework in the first quarter of 2017 with a working group providing feedback on a number of significant issues which FINMA accepted:
  - Timeline for implementation: FINMA has decided to postpone go-live of the NSFR in Switzerland by one year to January 1, 2019
  - Intra-group financing: FINMA has aligned the RSF/ASF factor requirements for intragroup financing with the third party requirements
  - ASF factors for large deposits: FINMA had originally proposed lower ASF factors for certain deposits but decided to align the ASF factors with the BCBS standard as a result of the consultation

- A number of discussion points remain open with FINMA:
  - Treatment of bail-in bonds (TLAC instruments): treatment of early redemption options when determining remaining maturity
  - Interdependent assets and liabilities: FINMA considering allowing for only limited benefit for linked transactions
  - Classification of credit and liquidity facilities for LCR: treatment of acquisition facilities

- We appreciate the constructive dialogue we have had with FINMA on this topic, but we are beginning to see many of the theoretical concerns that were discussed during the Basel consultative process on the NSFR coming to fruition. These key features of the NSFR may, in turn, undermine market liquidity and possibly be counter-productive to systemic safety.
2. Key Implementation Issues
Key Implementation Issues: Haircuts on Level 2B Assets

- The proposed haircuts do not appropriately reflect the demonstrated performance of equities under both normal and stressed conditions:
  - Can be reasonably monetized under stressed conditions
  - Demonstrated resilience through sustained secured funding markets as evident throughout the 2008/2009 stressed conditions per Fed’s own White Paper review

- Any funding risk associated with price volatility in exchange-traded equities is largely mitigated through a number of operational and legal safeguards offered by the market:
  - Exchange traded equities are highly liquid, even in times of stress (banks can liquidate holdings in a very short amount of time, and are therefore not exposed to price volatility over extended periods of time)
  - To the extent that banks are required to hold an Equity as part of structure or as a hedge, the price volatility will be mitigated through other transactions in the structure, and liquidity risk will be met through daily variation margin

- In our view, haircuts should be reflected to reflect the above considerations. Our recommendations are already greater than haircut widenings seen during 2008 dislocation:
  - Major market main index equities should receive an RSF factor of 15 percent including exchange-traded funds (ETFs) that track a major market main index (MSCI constituents including Korea, Brazil & Taiwan);
  - All other major market equities traded on an exchange, but not included in the main index, should receive an RSF factor of 50%;
  - All other equities should receive an RSF factor of 100%; and
  - An exemption should apply to equities qualifying for treatment as a linked transaction.
Key Implementation Issues: Interdependent Assets and Liabilities

- The original BCBS NSFR framework allows for the application of a 0% ASF factor and a 0% RSF factor to interdependent assets and liabilities under contractual arrangements that meet certain criteria (Paragraph 45).

- The proposed U.S. rule differs in this regard. As stated in the proposed rule, the agencies do not believe that U.S. banking organizations engage in transactions that would meet the criteria as specified in the BCBS rule, and hence the U.S. NPR does not include a framework for interdependent assets and liabilities.

- CS recommends that any final NSFR requirement should appropriately recognize certain circumstances where the existence of specific liquidity, credit, market, and operational risk considerations support recognition of the transactions as linked or self-funded:
  - Banks commonly act as market intermediaries to facilitate client trading strategies.
  - There are common derivative strategies where banks carry cash equity inventory without material market or funding risk, and where symmetrical unwind of the ‘package’ is assured through credit, liquidity, and market risk safeguards.
  - A limited number of ring-fenced exemptions for these transactions should be incorporated based on clear criteria.
Key Implementation Issues: Interdependent Assets and Liabilities

- Inventory held as hedge to client facing swaps:
  - Driven purely by client demand: clients execute TRS as synthetic secured funding transaction whereby the swap agreement ensures a full pass through of the performance of the hedge to the client.
  - Changes in value of hedge are offset by changes in the value of the swap, which are then met with regularly posted variation margin.
  - The swap is recorded under ISDA PSA documentation, which will reference details of the reference security.
  - Tenor of such swaps range from overnight to 1 year with majority of swaps terminable by the client or bank in 180 days or less.
  - Termination provisions give banks the ability to move the final termination date if it cannot affect the unwind of the hedge.
  - As a result, equity hedges held in this way exhibit maturity characteristics similar to those of the swap agreement. Under proposed rule current RSF factors provide no recognition of a bank’s ability to liquidate the hedge at the swap maturity.

- Cash borrows covering shorts:
  - CS recommends that when a bank borrows a security vs cash to cover firm or client short position, NSFR should recognize an exception from RSF factors applies to loans, and instead recognize equal and offsetting ASF and RSF factors.
  - This would avoid potential asymmetry: when clients terminate trades, bank receives the security back and return security to third party, currently attracting 0 percent ASF and 15 percent RSF if assumed to be < 6 months and done with non-bank financials.
3. Potential Application of the NSFR to IHCs
An IHC NSFR Requirement Would Be Duplicative

As you know, the proposed NSFR rule does not extend to IHCs. This is appropriate, given that IHCs are - or soon will - be subject to the following overlapping requirements that already accomplish many of the same goals:

- The Regulation YY liquidity buffer;
- The Comprehensive Liquidity Assessment and Review (CLAR) assessment;
- The Comprehensive Capital Analysis and Review (CCAR), which provides incentives for IHCs to hold longer-maturity loans from their parent;
- Total Loss Absorbing Capacity (TLAC) rules that require IHCs such as CS to hold significant convertible internal long-term debt and equity;
- Liquidity Coverage Ratio (LCR) requirements at the group-level; and
- A robust NSFR requirement at the group level.
An IHC NSFR is Unnecessary Given Commitment of Parent

- In addition, standing behind the IHC will be a parent that must comply with its home country liquidity, funding and capital standards, which, in the case of Credit Suisse, will include a robust NSFR requirement mandated by FINMA.

- The parent is also the sole capital investor in the IHC and provides the entity with substantially all required unsecured funding. Given the substantial capital investment in the IHC and the NSFR-demonstrated sufficiency of term funding resources, the parent would have no incentive to starve the IHC of funding during a crisis.

- In short, the combination of local and global standards ensures that local resources are on hand to meet stressed outflows and absorb losses while the robust liquidity and funding position of the consolidated group provides a safeguard against forced liquidation of assets amid a financial crisis.

- Moreover, a separate stable funding requirement at the subsidiary level may create internal obstacles that impede the ability of a global institution to respond to a crisis. In this way, it may undermine, rather than Enhance, the stability and resilience of the financial system.

**Financial Commitment of Parent Firm to IHC**

- **Short Term Debt**: Funding of the IHC's liquid asset portfolio and other short term activities
- **Long Term Debt**: Stable, long term funding that minimizes short term refinancing risk
- **Loss Absorbing Debt**: Long term loans that can either be written down or converted to capital in the IHC
- **Loss Absorbing Capital**: Capital investment that exposes the parent to IHC losses
- **Total Capital**: Includes paid in capital and retained earnings (i.e. potential future dividend to the parent)
Recommendations for IHCs

- For the reasons stated, we do not believe a separate NSFR requirement is necessary or appropriate for IHCs

- If, however, an NSFR requirement were to be applied to IHCs in future, the Board should only do so on a “modified” basis:
  - This modified approach would be similar to the proposed NSFR requirement for BHCs with less than $250 billion but greater than $50 billion in total consolidated assets. Such firms would have to maintain a Required Stable Funding (RSF) amount equivalent to 70 percent
  - Application of this modified approach would be justified based on the multiplicity of existing liquidity requirements that IHCs are subject to and support from the IHC’s parent firm. It is also worth noting that almost all IHCs now fall below the proposed $250 billion in total U.S. consolidated assets threshold for full (non-modified) application of the NSFR