ICMA International Capital Market Association

NSFR and Reverse Repo

An ICMA briefing note on the change to the EU's NSFR Required Stable Funding factor for short-term reverse repos

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Overview

CRR provides that by 28 June 2025, the Net Stable Funding Ratio (NSFR) Required Stable Funding (RSF) factors applied to short-term securities financing transactions (SFTs) will be aligned with those envisaged by the Basel standards. For reverse repos with terms shorter than six months, this would take the RSF factors of transactions secured by Level 1 High Quality Liquid Assets (HQLA) from 0% to 10%, and the RSF of transactions secured by non-Level 1 HQLA from 5% to 15%.

ICMA and its members are concerned that these changes, particularly in the case of Level 1 HQLA, would increase the cost of providing liquidity in the EU repo market, which would either be passed on to users of the market in the form of wider bid-ask spreads or reduced liquidity. Furthermore, at a time when we are seeing an attrition of market-makers, both in EU sovereign and corporate bond markets, any increase in the marginal costs to traditional liquidity providers runs the risk of contracting the dealer pool further, resulting in a less diverse market structure and a greater concentration among banks better positioned to absorb these additional costs. The outcome would be to undermine the competitiveness of the EU's financial sector, putting EU banks at a significant disadvantage compared to their peers in other key jurisdictions who are subject to lower RSF factors. Ultimately, this is a cost not only to investors in EU bond markets, who must pay wider bid-ask spreads, but also to issuers, including EU sovereigns, who must pay more to access the market.

The risk to the smooth functioning of government bond markets from putting more constraints on primary dealers has been highlighted in ICMA's recently published report: *Liquidity and Resilience in the Core European Government Bond Markets.* This risk becomes even more stark at a time when the ECB is tightening monetary policy with the potential for active asset sales ("Quantitative Tightening") in sight.

ICMA and its members would argue strongly that maintaining the current 0% RSF for Level 1 HQLA and 5% for non-Level 1 HQLA would not only be consistent with other jurisdictions, such as the US, UK, Canada, and Japan, but is important from the perspective of liquidity and resilience of the EU's sovereign, SSA, and corporate bond and repo markets. Something originally recognised by the co-legislators in calibrating CRR II.

Background

CRR II (Regulation (EU) No 2019/876), which amended CRR (Regulation (EU) No 575/2013), reduced the required stable funding factor applied to short-term reverse repos in Level 1 HQLA from 5% to 0% for the duration of a limited "phase-in" period. According to Recital (50) of the Regulation, this was seen as important because a higher RSF:

"…could potentially further incentivise institutions to deposit cash at central banks rather than to act as primary dealers and provide liquidity in sovereign bond markets. Moreover, it is not consistent with the LCR that recognises the full liquidity of those assets even in time of severe liquidity stress."

However, Article 8 of the Regulation provides that this RSF factor should increase from 0% to 10% by 28 June 2025, "*unless otherwise specified in a legislative act adopted on the basis of a proposal by the Commission".* This would bring the RSF factor in line with that proposed under the BCBS Basel III NSFR framework.

Articles 510(4), (6) and (9) of CRR and CRR II mandated the EBA to evaluate several aspects of the NSFR framework, including the RSF calibration for short-term SFTs secured by Level 1 HQLA, by June 2024. On 16 January 2024, the EBA published: *Report on Specific Aspects of the NSFR Framework Under Article 510 (4), (6) and (9) of Regulation (EU) No 575/2013.* Following its analysis, the EBA concluded that:

"As regards the treatment of SFTs and unsecured transactions with a residual maturity of less than six months with financial counterparties, it is recommended to comply with Basel standards after the phase-in period as envisaged in the CRR."

Cost and impacts

Overall repo market

ICMA has estimated the cost to the EU banking system as a result of the imposition of a 10% RSF on <6mth borrowing secured by Level 1 HQLA.[1] This conservative estimate is based on the latest ICMA European Repo Survey, which provides a snapshot of the European repo market as of December 2023.[2] The headline number of the size of the European repo market is €10,900bn. This number includes EU subsidiaries of non-EU banks, as well as EU-headquartered banks.[3] Since the survey is estimated to represent around 80% of the true market size, we can therefore assume the true total outstanding value to be €13,625bn. Of this, 52.7% is made up of reverse repos. Of these, 73.2% has a maturity <6mths. Based on an overall estimate of 85.6% of outstandings being L1 HQLA, of which 54.7% being in scope of EU NSFR,[4] that suggests that **€2,460bn of the European repo market would be impacted by 10% RSF factor**.[5]

This would create a requirement for **an additional €246bn of stable funding** by EU banks. All things being equal, based on the most conservative cost of borrowing long-term stable funding,[6] this would result in an **annual cost of €1.6bn** to the EU banking sector. This cost inevitably arises for EU headquartered banks as they consolidate their NSFR in the EU, while non-EU headquartered banks would have some flexibility to mitigate the EU NSFR cost on a non-EU consolidated basis if or when having recourse to intragroup transactions. And while the EBA notes that the NSFR buffers of EU

[1] Similar consideration would need to be given for non-Level 1 HQLA assets, however ICMA has not undertaken that analysis for the purposes of this note.
[2] The December 2023 survey will be published in the next weeks. Earlier editions of the survey are available on the ICMA website. All the following figures are based on the latest survey results.
[3] Analysis based purely on EU-headquartered banks will therefore produce a smaller additional NSFR requirement and total cost.
[4] Note that this is estimated by disaggregating data collected on the ICMA Survey which otherwise includes non-EU entities.
[5] ICMA notes that this does not account for the effect of netting, and so may be an overestimate.
[6] This is based on the premium derived from the 5yr iTraxx Senior Unsecured CDS (0.65%).

banks are currently sufficiently high to absorb most of the required increase, we would point out that banks are unlikely to run down the current buffer level to meet additional funding requirements. Rather they would look to maintain the same level of headroom. It is also important to note that this additional stable funding would need to be 'sterilized' so as to avoid further NSFR requirements, and would accordingly sit idle, and mainly deposited with EU central banks (as originally anticipated by the co-legislators).

Government bond market

ICMA further estimated the annual cost that this would generate specifically for market-makers in EU sovereign bonds. Based purely on EU27 government bonds, MiFIR/D II publicly reported data for 2023 shows a average weekly trading volume (notional value) of €400bn.[7] This excludes dealer-to-dealer (D2D) trading volumes, and constitutes dealer-to-client (D2C) transactions, both on and off venue. It is reasonable to assume that 50% of these volumes involve a dealer selling. Based on feedback from ICMA sell-side members, it is further assumed that 30% of these sales are not related to inventory held on the market-maker's books, and therefore involve the dealer 'going short'. We then conservatively estimate that 50% of shorts will be bought back for the same day. This implies that market-makers in EU government bonds have an average short-term borrowing requirement against €30bn of traded volumes per week, which would be impacted by the increase in the NSFR RSF factor.[8]

It is also important to note that this increase in the long-term funding requirement to support market-making will apply to all bond classes, including public sector bonds and supranationals, all covered bonds, and securitization tranches.

These estimates, based on available market data, illustrate the materiality of the impact on the EU repo market as well as the cost of liquidity provision in both EU government and corporate bond markets. The result will likely be not only wider bid-ask spreads in repo rates, but also in government and other bond prices, effectively passing these costs on to investors. As mentioned above, and perhaps even more significantly, these additional costs may force some investment firms to reconsider their commitment to providing liquidity in certain EU bond markets.

Conclusion

At a time when the EU sovereign bond market has grown significantly in size, and the ECB is embarking on tighter monetary policy along with the reduction of its bond under the various purchase programmes, market stability is highly reliant on the smooth functioning of the repo and government bond markets, which in turn is dependent on the capacity of banks as liquidity providers and market-makers. Introducing material additional costs and constraints on bank intermediation by applying the asymmetric NSFR treatment envisaged by Basel III for short-term reverse-repos in Level 1 HQLA would seem counterintuitive to the objective of liquid and resilient EU bond and repo markets, making them ever more vulnerable to stress events. Similarly, increasing the RSF factor for short-term reverse-repos in non-Level 1 HQLA from 5% to 15% would create material additional costs

[7] ICMA uses Propellant.digital software to aggregate publicly reported post-trade data under the MiFIR/D II obligation

[8] The total cost to EU regulated banks would be contingent on the rate of turnover of short positions and therefore the average quantum of stock being borrowed by market makers.

for market-makers, which would also likely be passed on to investors and issuers in the form of wider bid-ask spreads, reduced liquidity, and higher dealer concentration.

ICMA believes that the EU should align itself with other major jurisdictions in maintaining an RSF factor of 0% for short-term reverse repos in the highest quality liquidity assets, and 5% for other securities, not only to protect the liquidity and resilience of EU bond markets, but also to ensure that they remain globally competitive.

ICMA would further recommend that the necessary revisions to the CRR Level 1 are proposed by the Commission well in advance of June 2025 so as to ensure sufficient time for the legislative process before the current changes to the EU RSF calibrations come into effect.

The International Capital Market Association (ICMA) promotes well-functioning cross-border capital markets, which are essential to fund sustainable economic growth. It is a not-for-profit membership association with offices in Zurich, London, Paris, Brussels, and Hong Kong, serving over 620 members in 68 jurisdictions globally. Its members include private and public sector issuers, banks and securities dealers, asset and fund managers, insurance companies, law firms, capital market infrastructure providers and central banks. ICMA provides industry-driven standards and recommendations, prioritising three core fixed income market areas: primary, secondary and repo and collateral, with cross-cutting themes of sustainable finance and FinTech and digitalisation. ICMA works with regulatory and governmental authorities, helping to ensure that financial regulation supports stable and efficient capital markets.

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