BCBS Consultation on recalibration of shocks for interest rate risk in the banking book – ALMA and UK Finance joint Industry response

1. Introduction

UK Finance and Asset & Liability Management Association (ALMA) members support the Basel Committee on Bank Supervision (BCBS) review and consultation of the interest rate shocks used in the Interest Rate Risk in the Banking Book (IRRBB) standards, to ensure they remain fit for purpose. The standards should allow for consistent comparisons across firms and jurisdictions, rather than constraining firms from effectively managing their interest rate risk where regulatory assumptions materially differ from a firm's internal assessment.

By way of background, ALMA[1] is a trade association of asset & liability risk management practitioners in banks, building societies and other related companies, with over 100 member institutions in the UK, Ireland and internationally. ALMA's primary aims are to provide education and promote awareness and best practice in asset and liability risk management issues, through provision of courses, conferences, masterclasses and networking events. UK Finance[2] is a trade association for the UK banking and financial services sector. It represents over 300 firms in the UK providing credit, banking, markets and payment-related services. The association formulates policy for its members, advocates those policies with HM Government, regulators and the media, and supports industry collaboration in the interests of efficiency and better customer outcomes.

To gauge industry views on the IRRBB consultation, a survey of ALMA members was undertaken. 14 firms responded to the survey from a range of institutions; including G-SIB's, O-SII's, UK banks with >£20bn balance sheet, Small Domestic Deposit Takers and branches/subsidiaries of international banks. The collective views of respondents are represented in the response herein.

Our detailed feedback is below, but in summary:

- Members acknowledge the need to refresh the time series used to calibrate the interest rate shocks and support the BCBS' proposal to switch from using relative shocks to absolute shocks to address the limitations in the current methodology. However, members consider that there needs to be a stronger justification provided for increasing the confidence level (from 99 to 99.9 percentile value), at this stage, and have concerns that this change, combined with the current rounding methodology may have the potential to amplify shock sizes and lead to unrealistic shocks.
- Members feel it is important to ensure that overall levels of prudence are appropriate, including considering whether aspects of the standards that have not been changed are now overly prudent, relative to those aspects where changes have been proposed.
- Calibration should be consistent when compared to other parts of the Basel framework.
- Consideration should be given to the potential impacts on bank balance sheets, and subsequent provision of credit and other services to the wider economy, as well as other unintended consequences with regards both firm and wider economy impacts.

We hope that our response is helpful for the further assessment of the proposed adjustments to the IRRBB standards, and we would be happy to engage further where additional information or input from our members would be helpful.

[1] ALMA was formed in 1992

[2] UK Finance was formed in 2017 as a result of a merger of the British Bankers' Association, Payments UK, the Council of Mortgage Lenders, the UK Cards Association and the Asset Based Finance Association.

2. Overview of feedback on key technical changes proposed

Members' comments on the technical aspects of the proposal focused on the following elements:

i. Using relative rather than absolute shock and based on currency specific factors rather than a combination of global and local factors.
ii. Increase in the observation time series from 16 to 23 years.
iii. Increase in shock moving from 99th to 99.9th percentile values without any proposed change to the Supervisory Outlier Test.
iv. The instantaneous application of the shocks and without consideration of the point in time level of interest rates.
v. Rounding the calculated shocks to the nearest 50bps.

i. Migration to absolute rate shocks and currency specific factors

Members' feedback to the proposed changes to move from relative to absolute shocks was generally supportive given this tended to result in more homogenous and comparable shocks across different time periods and rate environments. Linked to this methodology change, most members were supportive of the move to currency specific shock factors rather than a combination of global and local factors.

ii. Increase the length of the observation period from 16 to 23 years

Members acknowledged the need to refresh the time series used to calibrate the interest rate shocks. However, not all members supported the proposal to extend the time series from 16 years to 23 years without clarification on BCBS' approach to adoption of a rolling time series of a specified fixed length. This would allow banks to anticipate guidance relating to future SOT computations and would assist planning and preparation. One member suggested that a rolling timeframe of 20 or 25 years would be appropriate. Without this clarity it is difficult for members to understand what the committee is aiming to solve for, and what principles are to be applied consistently over time.

In this respect, one member noted that benchmarks may change over time so that historic data becomes less relevant when setting shocks. For example, GBP underwent RFR transition at end 2021, but the rolling history proposed continues to incorporate periods when GBP LIBOR was a benchmark index.

iii. Increase in shock from 99^{th} to 99.9^{th} percentile value

Members raised several concerns regarding the proposed increase in shocks from 99^{th} to 99.9^{th} percentile value. **Most members were not supportive of this proposal for the following reasons:**

- Members questioned the Committee's proposal to increase the percentile from 99^{th} to 99.9^{th} considering increasing the timeframe for observations adds more points to the actual distribution and represents the fluctuation and movement of interest rates more fully.

- Members also questioned the move from relative to absolute shocks which in combination with the change in percentile does not form a more 'accommodative methodology'. Our analysis shows that the change in methodology from relative to absolute shocks on the current time series data for GBP, would not have resulted in a reduction in the rounded shock levels for parallel and long shocks and would have increased the short rate shock at the 99^{th} percentile value level.

- Members noted that the short rate shock for GBP would continue to be driven by the global financial crisis ('GFC') observation period, with the long rate and parallel shocks under the 99.9^{th} percentile value approach now being driven by the extreme but brief market volatility observed following the UK's 'Mini-budget crisis' in September 2022. We believe this highlights a fundamental flaw in the increase to the 99.9^{th} percentile value, where the unrounded shocks are based on the 6th most severe datapoint within a time series of c. 6,000 observations. The methodology is reliant on a few extreme, momentary outlier points that do not translate into a sustained impact suitable for application in IRRBB metrics. In addition, members questioned whether the proposal is likely to introduce increased volatility in the future calibration of shocks under the proposed methodology.

- We also consider that the increase to the 99.9th percentile value is inconsistent with the calibration used in other Basel frameworks and specifically in FRTB, raising concerns about the overall consistency of the Basel 3.1 framework. In particular, Basel 3.1 allows banks subject to conditions to transfer interest rate risks in the banking book to an internal risk transfer desk in the trading book. In the trading book, interest rate risks are then subject to significantly lower pillar 1 shocks under FRTB. While there is already a difference between IRRBB and FRTB shocks under the current calibration, we are concerned that the proposed calibration increases the disconnect between these frameworks. We consider that some consistency between the IRRBB and FRTB frameworks is crucial to avoid introducing incentives for regulatory arbitrage and to ensure a harmonised approach to risk management.

- The increased severity moves the purpose of the disclosure away from comparability between firms and towards a tightening of capital constraints.

Members do not support the proposal to increase the percentile value from the 99th to 99.9th at this stage and consider that the shocks arising from this do not achieve the appropriate level of prudence. The current percentile value should be maintained given it is more likely to lead to a consistent long-term level of calibrated shocks, after allowing for periodic recalibration.

iv. Instantaneous application of the shocks

Related to the concerns addressed in point (iii) above, members noted that while the methodology proposed is based on a movement in rates over a rolling 6 month time period, banks are required to apply the rate shocks instantaneously. Although the 6 month observation does not represent a change in methodology, it embeds a level of conservatism into the approach. Some members were not supportive of the 6 month observation period.

v. Rounding shocks to the nearest 50 basis points

Members raised concerns about the rounding of calculated shocks to the nearest 50 basis points, where the movement in shocks of a small number of basis points near the middle of the range could result in a relatively large step up or down in the applied shock levels. Members generally agreed that reduced the rounding to the nearest 10 or 25 basis points would reduce the cliff edge effects to commensurate with the long-term nature of the calibration approach.

Furthermore, members have concerns that the increased 99.9th percentile value, combined with the subsequent rounding methodology could amplify shock sizes, equivalent to extreme and seldom observed rate moves.

vi. Conclusion

Members were also concerned that, in combination, the changes discussed above could have unintended consequences. Increasing the observation period to capture a period of elevated volatility (particularly for GBP), using a 99.9th percentile value and continuing to apply the current rounding methodology may lead to unrealistically high shocks being applied that are overly conservative and which contravene the Committee's objectives of 'maintaining sufficient conservatism'.

The BCBS itself acknowledges that it needs to consider further whether there may be any unintended consequences. We consider that it would be more appropriate for the BCBS to wait until the outcome of the review (non-parallel shocks and US banking turmoil) before proposing any changes to the methodology and calibration of the IRRBB shocks to avoid the need for subsequent changes at a later stage.

3. Banks' operational preparedness for implementation

Members are broadly comfortable with their ability to make the required changes to their modelling, risk appetite and governance frameworks. However, it should be noted that members require sufficient notice of any finalised changes in order to have time to develop, integrate and test those changes through their systems and processes, as well as make any business changes as a result. We consider that a minimum lead time of a year would be required for members to make these changes.

4. Impact on balance sheet models, risk appetite, future direction & unintended consequences

Balance Sheet Impact

Around a third of members advised there would be no impact to their firm's balance sheet strategy as a result of the proposed changes. At the other end of the scale, just over 20% expected to experience a material change – all of these were larger member firms; being either a G-SIB or an international firm with a UK branch or subsidiary.

Impacts called out ranged from a reduction in the level of product flexibility a firm was able to offer, to impacts on hedging approach in stabilising earnings through equity investments, to capital strategy. However, capital strategy within an IRB firm would likely be mitigated through better internal modelling at larger firms.

Firms aim to balance the dynamic between earnings in the shorter term and value in the longer term. An excessively prudent approach to shocks for UK firms is likely to have an impact on internal earnings metrics. Members were concerned that increased focus on a value metric could fundamentally alter firms' approaches to earning management, perhaps by accepting more earnings volatility.

Ultimately, a more constrained operating environment, presented through higher shocks within the EVE SOT, requires closer monitoring of emerging balance sheet exposures and could restrict balance sheet growth in terms of both size and product range, due to the exclusion of own equity in the calculation. Under the standardised framework, firms are already required to use rate conditioned customer behaviours in their modelling and some firms may already utilise more dynamic balance sheet modelling to accommodate the impact of greater volatility in the external environment, leading to a compounding of the constraint to product offerings and firm growth.

Risk Appetite

With regard to internal risk appetite and risk management, firms were asked whether the proposal would directly result in a change in practice with the vast majority advising that there would be some impact – around a third of which said their firms would be greatly impacted.

A number of firms advised that a review of internal risk appetite levels would be required and expected the increased level of the shocks to result in corresponding increases in both value and earnings metrics. A particular concern was an increased requirement for close management to balance efficiency, with earnings optimisation. One larger firm specifically called out a binding constraint of a 'parallel up' scenario which would now be closer to the 'long rates up' scenario within the SOT.

In addition, one small domestic deposit taker (SDDT) stated that there would be an impact on Pillar 2A capital requirements. Again, closer monitoring on exposures was called out as a mitigant to increases in the sizes of shocks.

Future Direction

A number of firms responded that there would be a change to their balance sheet strategy including concerns that the flexibility offered to customers would be impacted. In the UK, particularly for retail products, significant optionality is embedded in products due to both FCA regulation[3] and industry norms. It is unlikely that a reduction in this flexibility would be feasible – particularly in the current economic and political environment. Therefore, any restriction would manifest itself in balance sheet growth.

A tightening of risk management would lead to a reduction in appetite to grow balance sheets with additional capital constraints, increased earnings instability and greater resource allocated to risk management activities. Within the current UK economic environment, the majority of firms are facing cost pressures reducing the possibility of increasing team sizes to actively manage risks and compounding the restriction in balance sheet growth.

Unintended Consequences

Members recognised the need to update the time series with consideration to the current environment, some saying it was "inevitable". However, ensuing implications for customer offerings and the impact on risk management practices were called out. One firm suggested that managing to higher shocks could result in tighter risk management and a concentration of strategies: reducing balance sheet duration and resulting in negative impacts in times of economic decline or contagion.

Moving shocks to a remote event, as indicated by use of the 99.9th percentile value, could have an impact on capital requirements for smaller firms. This is because such firms are more likely to utilise the regulatory framework to support their analysis within ICAAP submissions. Even for larger firms, the shocks are much more severe than conservative risk management would indicate.

Conclusion

Considering members' feedback, ALMA and UK Finance recommendations would be to:

- **Maintain shocks at the 99th percentile value;**
- **Define the methodology around the length and horizon of the observation window;**
- **To reduce the rounding threshold from 50bps to 25bps;**
- **Consider the holistic IRRBB management including both earnings and value metrics; and**
- **Ensure consistency with other live and emerging regulations.**

ALMA and UK Finance are supportive of further engagement should that be valuable to BCBS and can be contacted on liaison@ukalma.org.uk.

[3] Consumer Duty | FCA