

To: Basel Committee on Banking Supervision
From: Arion Bank, Iceland

Reykjavík, September 9 2015

Subject: Comments on Basel Committee's 2015 Consultative document on Interest rate risk in the banking book

The purpose of this submission is to give attention to a special case for interest rate risk in the banking book (IRRBB), namely for that of real interest rates and related price risk for index-linked instruments. This case, although not common worldwide, is highly important for individual economies and stresses the importance of not adopting a one-size-fits-all methodology.

Indexed-linked debt instruments with fixed interest rates are a major part of the Icelandic economy. Over 80% of all mortgages are index-linked to the Consumer Price Index (CPI) and housing and covered bonds issues are predominantly CPI-linked. As rates can be fixed for up to 40 years, the IRRBB methodology is especially important for Icelandic banks. While the Basel document focuses on nominal interest rates, the fair value of indexed-linked instruments is a function of real interest rates and the CPI.

The Bank argues that the dynamics of real interest rates are different from that of nominal rates. Using the language of time-series analysis, the hypothesis is that real interest rates are stationary while inflation and nominal rates are co-integrated. This is reflected in the monetary policy of central bankers, who tend to use an „equilibrium real interest rate“ as benchmark in rate setting, i.e. the Taylor rule, thus giving rise to the interplay between inflation and nominal rates. We claim that real interest rates are in a sense *mean reverting*, theoretically moving in line with GDP, with movements often lagging between central bank rate settings. As a result, the annualized volatility is overestimated and the tail distribution is skewed if implied from daily fluctuations or from any model where the long-term mean reversion is not accounted for. The argument is in turn reflected by the fact that Icelandic financial institutions are able to offer rates fixed for up to 40 years.

This example shows the importance of not adopting a one-size-fits-all methodology and the importance of encouraging national discretion when it comes to the evaluation of IRRBB.

How does this case fit into Basel's proposed methodology for selecting and calibrating prescribed interest rate shock scenarios?

In Iceland, there are effectively two major currencies, i.e. the non-indexed krona and the indexed krona, so the market risk in question is a function of three factors: the nominal forward curve, the real forward curve and the CPI (as the price of indexed instruments is directly linked to the CPI). As the expectation of inflation is a major factor in the determination of nominal

interest rates, diversification effects are strong. Furthermore, inflation is obviously highly correlated with the exchange rate of the krona against foreign currencies.

This case shows the importance of taking diversification effects into account in IRRBB, as the Committee has clearly stated:

“...some consideration needs to be made as to the degree of offsetting and/or diversification along with the dependency between rate movements across different currencies. Given that it is fairly unlikely that similar interest rate shock scenarios occur simultaneously (each in a different currency) prudent offsetting of losses through gains across currencies can be justified.”

The undersigned are however concerned that regulators could strictly interpret the consultation such that IRRBB and indexation risk (the risk of loss to economic value and/or earnings for indexed assets and liabilities due to changes in the CPI) should be treated independently despite the obvious interplay.

Will the Committee advise on the relationship between IRRBB and price risk for indexed-linked instruments or indicate that the aforementioned indexation risk should be treated within the scope of IRRBB, or alternatively that diversification effects should be considered between the risks?

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