

**ABI response to the
BCBS Consultative Document
“Interest Rate Risk in the Banking Book”**

September 2015

The Italian Banking Association (ABI) welcomes the opportunity to contribute to the consultative document on *Interest Rate Risk in the Banking Book* (IRRBB).

As a preliminary remark, ABI firmly agrees with the arguments proposed by the European Banking Federation (EBF) in their response. In this paper, ABI intends to cite further evidence arising from a country-specific background.

In general, ABI would like to highlight two main points:

1. The Banking Book should be positively defined, i.e. an “eligibility principle” should be applied instead of considering the Banking Book to be everything not included in the Trading Book;
2. A Pillar 2 framework should be adopted, based on Binding Sound Practice Principles together with Tests to Identify Potential Outlier Banks.

Moreover, as shown in the following Sections A and B, ABI observes that:

- A. IRRBB should be measured based on interest rate sensitive flows only, to avoid commingling with other risk elements. As an example, Section A shows that the use of customer rates, i.e. the inclusion of margins used to remunerate other types of risk, could bias IRRBB measures;
- B. A standardised approach would preclude banks from swiftly adapting to changes in the competitive environment. As an example, Section B provides evidence that the treatment of impairment loans needs a tailored approach.

Section A: Cash flow bucketing and outlier tests

While ABI supports Outlier Tests based on Economic Value sensitivity, it recommends considering the following evidence in order to define a better EVE measurement framework.

The Consultative Document (page 14) defines notional repricing cash flows of the interest payments as:

*“any interest payment on a tranche of principal that has not yet been repaid or repriced; where material, spread components of interest payments on a tranche of principal that has not yet been repaid and which do not reprice **must be slotted until their contractual maturity** irrespective of whether the non-amortised principal has been repriced or not.”* (bold added)

ABI observes that IRRBB should refer only to a measure of the interest rate component of contractual flows and positions should be accounted for at the contractual (floating) rate or at the inception swap rate.

In fact, in the IRRBB framework, the inclusion of the spread component could lead to a biased measure of Economic Value.

As an example, let us consider a (bought) fixed-coupon bond, where **N** is the notional amount, **C** the coupon rate, time T_i varies from T_1 to T_M , and, possibly, a default occurs at the time T_{def} with a loss equal to $(1-RR)$.

BOND	
	Rec Pay
T_0	-N
T_i	+C
T_M	+N
T_{def}	+N*RR

if no default occurs
if default at T_{def}

Such a position can be replicated with a credit-contingent IRS, a CDS on the bond issuer and a reverse repo, as the following scheme shows:

	ASW CC		CDS		Reverse Repo	
	Rec	Pay	Rec	Pay	Rec	Pay
T_0						-N
T_i	+C	-r-ASW _{spread}	+S		+r+L	
T_M					+N	
T_{def}				-N*(1-RR)	+N	

if no default occurs
if default at T_{def}

where **r** is the risk-free floating rate, **S** is the market CDS premium, **L** is the “liquidity” spread on the reverse repo and **ASW_{spread}** is the credit-contingent asset swap spread. In this scheme, spread components provide “remuneration” for credit and liquidity risks.

When the equation **ASW_{spread} = S + L** holds, the bond and the replicating portfolio have the same payoff in all possible scenarios. Moreover, once such equation is set, the two portfolios have common sensitivities.

In the replicating portfolio, the credit-contingent swap sets up the sole position carrying an interest rate sensitivity, while both the CDS and the reverse repo have zero interest rate sensitivity at inception.

Therefore, the bond's cash flow can be stripped of spread components that are "remuneration" for different risks, i.e. "fair value remuneration" for credit and liquidity risks can be subtracted from contractual flows.

In actuality, every cash flow should be multiplied by the relevant non-default probability (NDP), but stripping and assigning relevant NDPs to every cash flow can be a burdensome task for many banks. Therefore, a manageable fallback measure should be available.

In the above example, one option is to project fixed-rate positions using the equivalent swap rate at inception, neglecting the credit-contingent nature of the claim. This approximation could only lead to a biased measure when the interest-rate curve slopes steeply.

Section B: treatment of impaired loans and standardisation

As exemplified in the previous section, in considering cash flows, credit risk can be separated from interest rate risk. Sometimes separating the components can be difficult and tailored solutions are therefore necessary.

This is particularly true for impaired loans, where a standardised methodology based on a simplified approach is not adequate to fit the actual IRRBB.

A loan is impaired when, based on current information and events, it is probable that an institution will be unable to collect all amounts due in a timely manner according to the contractual terms of the loan agreement.

According to Italian regulations, non-performing loans (NPL) are classified into three categories:

- Bad loans: exposures to an insolvent counterparty (even if insolvency is not legally established) or in equivalent situations, regardless of any loss estimate made by the bank and irrespective of any possible collateral or guarantee;
- Unlikely to pay loans: exposures to a counterparty facing temporary difficulties – defined on the basis of objective factors - that are expected to be overcome within a reasonable period of time;
- Past due: exposures, other than those classified as bad loans and unlikely to pay, that are past due for more than 90 consecutive days.

Bad loans do not generate interest revenues, yet require funding at market rates. In the management of the embedded interest rate risk, the main goal is to reduce the NII volatility due to the mismatch between a non-interest

earning asset and the interest bearing liability used to finance these positions.

Likewise, a bad loan (net of provisions) can be considered as a non-interest earning asset financed by a non-interest earning liability (e.g. equity) and reduces the equity eligible for a replicating strategy. In this case, bad loans are usually excluded from the internal measurement systems for the IRRBB.

Bad loans can also be considered as financed by:

- Equity, for the portion that is not expected to be recovered (loan loss provision); and
- Other sources of funding, for the portion related to the recoverable amount.

In this case bad loans are indeed included in the internal measurement systems on the basis of their expected recoveries.

Recoveries are calculated using internal models taking into account collaterals and recovery procedures.

Unlikely to pay and past due NPLs generate cash flows that could be significantly different, in amount and timing, from the contractual ones. These loans also have a high probability of migration to bad loan status. The hedge ratio of these loans is lower than 100%: the higher the probability of migration, the lower the amount hedged, according to the contractual profile.