



September 11, 2015

BY ELECTRONIC SUBMISSION

Secretariat of the Basel Committee on Banking Supervision
Bank of International Settlements
CH-4002 Basel, Switzerland

Re: *Comments in response to the Consultative Document on Interest Rate Risk in the Banking Book*

Ladies and Gentlemen:

The Bank of New York Mellon Corporation (“BNY Mellon”) appreciates the opportunity to comment on the June 2015 Consultative Document issued by the Basel Committee on Banking Supervision (“BCBS”) regarding interest rate risk in the banking book (“IRRBB”).¹ This IRRBB Consultative Document would expand upon and replace the BCBS’s 2004 guidance, *Principles for the Management and Supervision of Interest Rate Risk*.²

BNY Mellon strongly supports the twin goals of the IRRBB proposal: “to ensure that banks have appropriate capital to cover potential losses from exposures to changes in interest rates,” and “to limit incentives for capital arbitrage.”³ Unfortunately, a Pillar 1 approach could undermine both of these goals. A one-size-fits-all approach could over- or under-estimate the maturities and interest rate risk of a bank’s portfolio due to the diversity in bank business models, products and services, asset-liability profiles, and risk management strategies. As a result, the proposed Pillar 1 measure would present a misleading and inaccurate view of a bank’s interest rate risk over time, and the Pillar 1 capital charges determined on the basis of these misleading measures would not be properly calibrated to cover losses due to changes in interest rates. A blunt Pillar 1 approach could even increase risk by creating incentives for banks to manage IRRBB to this regulatory capital measure rather than economic risk.

A robust Pillar 2 approach—without uniform or standardized Pillar 1 components—would better achieve the twin goals of the IRRBB Consultative Document. Each bank’s internal risk management and governance processes, under the robust supervision of national regulators, are best positioned to measure, monitor, and manage IRRBB.

¹ Basel Committee on Banking Supervision, *Consultative Document, Interest Rate Risk in the Banking Book* (June 2015).

² Basel Committee on Banking Supervision, *Principles for the Management and Supervision of Interest Rate Risk* (July 2004).

³ IRRBB Consultative Document, at 1.

This letter highlights several issues from the perspective of a custody and trust bank. Part I of this letter provides an overview of the BNY Mellon business model and balance sheet. Part II illustrates why a uniform Pillar 1 approach would not accurately reflect IRRBB for a custody and trust bank such as BNY Mellon, with a particular focus on non-maturity deposits. Part III suggests ways to improve the proposed Pillar 2 approach.

I. Overview of BNY Mellon

BNY Mellon is a global custody and trust bank focused on client servicing. We specialize in providing safekeeping, settlement, asset administration, trust, and other services to institutional clients. BNY Mellon's deposit levels principally are a by-product of these custodial and cash management services, and deposit liabilities inherently linked to the provision of operational services drive the custody and trust bank balance sheet.

These client deposits have a core, stable component and a variable component. Based on historical experience, clients leave a stable amount of deposits with custody banks to service day-to-day operational needs—these are generally defined as “operational deposits” in the Liquidity Coverage Ratio (“LCR”).⁴ The proceeds of this stable deposit funding customarily is invested in longer-term, liquid assets such as U.S. government bonds and similar instruments.

Clients also leave excess, variable deposits with custody banks as a result of the same operational servicing relationships—these are generally considered “excess” deposits. These excess deposits may result, for example, from a recently closed deal or a “flight to safety” during market stress. Due to the variable nature of these deposits, custody and trust banks predominantly place this excess cash at central banks.⁵

This low-risk asset-liability management strategy is distinct to the custody and trust bank business model to account for client cash flows based on servicing relationships. We believe that these conservative actions reflect prudent risk management, are consistent with supervisory expectations, and increase safety and soundness.

II. Pillar 1

Due to differences among bank business models, products and services, asset-liability profiles, and risk management strategies, the proposed Pillar 1 approach would not accurately reflect a bank's IRRBB over time and would not improve upon the measurement, monitoring, or management of interest rate risk. The proposed framework for non-maturity deposits would be particularly misleading for a custody and trust bank like BNY Mellon and would be inconsistent with previous BCBS determinations in the LCR. The proposed earnings-based net interest income framework is also flawed.

⁴ See, e.g., Basel Committee on Banking Supervision, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* ¶¶ 93-104 (Jan. 2013).

⁵ Historical experience shows a close correlation between the custody and trust banks' client deposits and central bank placements.

A. *Non-Maturity Deposits*

The June 2015 IRRBB Consultative Document defines non-maturity deposits (“NMDs”) as “liabilities of banks in which [the] depositor is free to withdraw at any time since they have no contractually agreed maturity date.”⁶ The Consultative Document recognizes that some of these NMDs are stable, core deposits: “part of the balances of NMDs behaves as a long term, rate-insensitive liability (insensitive even to large interest rate shocks).”⁷ The Consultative Document also recognizes that NMDs are not amenable to standardization because there is no uniform process for identifying core deposits given the diversity of products, interest rate levels and volatilities, customer behavior, and jurisdictions.⁸

Despite identifying numerous reasons why NMDs cannot be standardized, the IRRBB Consultative Document proposes to standardize many components of the NMD framework. It would separate NMDs into three categories (retail, retail transactional, and wholesale), impose uniform stability caps and pass-through floors, and assign uniform cash flow rates. This approach is overly prescriptive and would not accurately capture the universe of core deposits, the maturity of NMDs, or the interest rate risk of NMDs. These standardized parameters would be particularly inaccurate for the operational deposits of a custody and trust bank for several reasons.

First, the proposed categories would not reflect the diversity of NMD products. For example, the proposed categories overlook the important category of *wholesale transactional deposits*. Like retail transactional deposits, wholesale deposits also have a stable, transactional component. This is especially true for a custody and trust bank such as BNY Mellon, which receives customer deposits as a by-product of the operational services we provide. Wholesale customers maintain a stable level of deposits at custody and trust banks to ensure that the bank can carry out day-to-day payment, settlement, and other operational services for the customer.

The BCBS specifically recognizes these stable, wholesale transactional deposits as “operational deposits” in the LCR.⁹ These deposits receive a 25 percent outflow rate, as opposed to the higher 100 percent outflow rate for most other wholesale deposits.¹⁰ Both the BCBS LCR and national implementations of the LCR impose strict limits on the types of deposits that may qualify as operational.¹¹ For example, operational deposits must not provide customers with an economic incentive to leave excess deposits with the bank. This criterion is similar to the “absence of remuneration” criterion for retail transactional deposits in the IRRBB Consultative

⁶ IRRBB Consultative Document, at 19.

⁷ *Id.*

⁸ *See id.*

⁹ *See* Basel Committee on Banking Supervision, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* ¶¶ 93-104 (Jan. 2013).

¹⁰ *See id.*

¹¹ *See, e.g., id.*; 12 C.F.R. § 249.3 (definitions of “operational deposits” and “operational services”) & § 249.4(b).

Document.¹² Operational deposits, or wholesale transactional deposits, are subject to numerous additional criteria that ensure their stability.¹³

Second, the proposed stability caps and pass-through floors would overestimate the percentage of core deposits in some instances and underestimate them in others—all depending on the bank’s business model, products and services, changes in the interest rate environment, and other factors. The proposed framework effectively would impose a 33 percent limit on the amount of wholesale deposits that can be considered stable “core” deposits.¹⁴ This 33 percent limit likely would not reflect actual deposit profiles across banks. For example, a custody and trust bank likely has a larger percentage of core wholesale transactional deposits (*i.e.*, operational deposits) than a commercial bank due to the custody business model focus on operational servicing. Even within the same bank, the percentage of core to non-core wholesale deposits could change over time. The 33 percent figure could underestimate the percentage of core to non-core wholesale deposits in a normalized interest rate environment as excess deposits migrate to higher yielding products.

Third, the proposed cash flow slotting formula would compound inaccuracies in the NMD categories, stability caps, and pass-through floors. Non-core NMDs would be placed into the overnight time bucket, and core NMDs would be slotted in time buckets of one to six years, with an average maturity of three years.¹⁵ If the actual percentage of a bank’s core to non-core deposits is greater than the 33 percent limit, then the standardized cash flow slotting formula would underestimate the maturity profile of the bank’s NMDs. In addition, the average maturity for core deposits could be longer than three years. The resulting Pillar 1 NMD calculation, based on these inaccurate maturity estimates, would then misrepresent the interest rate risk of the bank’s NMD portfolio.

Although there is a “a trade-off between accuracy and simplicity” in the NMD calculation,¹⁶ a Pillar 1 approach could sacrifice so much accuracy as to be misleading—and without accompanying benefits. The over- and under-estimation of risk across banks and within the same bank over time could lead to several troubling consequences.

A Pillar 1 measure could create an incentive to hedge to the maturity and risk profile of the regulatory measure instead of internal economic estimates. This could actually increase risk as banks manage to regulatory instead of internal risk measures. Moreover, standardized regulatory measures could cause banks to cluster around the same investment horizons to match the standardized estimates of duration and risk. Banks that continue to manage to internal risk measures, consistent with supervisory expectations, may be at a disadvantage as

¹² IRRBB Consultative Document, at 20.

¹³ *See, e.g.*, 12 C.F.R. § 249.3 (definitions of “operational deposits” and “operational services”) & § 249.4(b).

¹⁴ *See* IRRBB Consultative Document, at 21, Table 4.

¹⁵ *See id.* at 21-22, Table 5.

¹⁶ *See id.* at 19.

they face higher capital charges. They could also face confusion from investors regarding differences between internal measures and regulatory measures, but may be unable to explain these differences without revealing proprietary or confidential supervisory information.

B. Net Interest Income – Variability versus Losses

BNY Mellon supports the goal of the IRRBB Consultative Document “to ensure that banks have appropriate capital to cover potential losses from exposures to changes in interest rates.”¹⁷ This is consistent with the traditional purpose of regulatory capital—to absorb losses.¹⁸

The proposed framework would go far beyond this, however, and require regulatory capital for fluctuations in opportunity cost rather than losses. The proposed Pillar 1 capital charge for IRRBB would have an earnings-based net interest income (“NII”) overlay based on expected changes in earnings levels.¹⁹ Such a measure would require capital for a downward change in earnings, even if the bank has overall positive earnings and no losses. This approach is inconsistent with the traditional purpose of regulatory capital to absorb losses.

Of course, banks should and do consider fluctuations in NII. Firms evaluate the risks to earnings based upon their own risk appetites and opportunity costs for earnings. Variability and volatility in earnings is an important part of BNY Mellon’s internal risk appetite, risk management analysis, governance process, and supervisory review.

C. Net Interest Income – Static versus Dynamic

The earnings-based NII approach would “ignore assumptions about a bank’s future business” using a static view of a bank’s balance sheet.²⁰ This static approach would not provide an accurate view of a bank’s interest rate risk and would be inconsistent with general bank risk management principles and supervisory expectations.

Interest rates change over time, assets mature, liabilities run-off, and new assets and liabilities are created. It is important for banks to look forward and account for these changes as part of their risk management analysis—both on a business-as-usual basis and on a stressed basis. At a custody and trust bank, for example, a wholesale customer may have a brief overdraft in a transactional wholesale deposit account as part of the normal payment and settlement process. This results in an overnight loan from the bank to the customer. On the very next day, the same customer could have a large incoming payment in the same account, which repays the loan and results in additional deposits. Over the course of the week, month, and year, the customer’s deposit account follows a predictable pattern that reflects the customer’s business cycle.

¹⁷ *Id.* at 1 (emphasis added).

¹⁸ *See, e.g.,* Basel Committee on Banking Supervision, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* 1-2 (Oct. 2010).

¹⁹ *See* IRRBB Consultative Document, at 31.

²⁰ *See id.*

Consistent with this reality, BNY Mellon manages interest rate risk as a dynamic, forward-looking process. This dynamic process is also consistent with supervisory expectations and is part of bank best practices. A static view of the balance sheet that ignores projections about future business would not provide an accurate view of a bank's interest rate risk profile and could create incentives to manage to this incorrect view of interest rate risk.

III. Pillar 2

For all the reasons described above, BNY Mellon believes that a Pillar 1 approach could detract from, rather than benefit, interest rate risk supervision and management. Instead, each bank's internal risk management and governance processes, under the robust supervision of national regulators, are best positioned to measure, monitor, and manage IRRBB. Each jurisdiction should have national discretion to implement the Pillar 2 supervisory process that is most appropriate for its banks. To this end, we strongly urge members of the BCBS to adopt a Pillar 2 approach that allows national discretion for implementation.

A. Pillar Integrity

A Pillar 2 supervisory approach should be a "pure" Pillar 2 approach without Pillar 1 calculations, comparisons, or disclosures. For example, any supervisory "outlier" determination based on a Pillar 1 approach would be misleading because the baseline determination (that is, the standardized Pillar 1 approach)²¹ would suffer from the inaccuracies described above with respect to business models, products and services, market environment, and other factors. An outlier test, or horizontal review, instead should be based on a Pillar 2 process that looks at a wide range of risk metrics across the bank.

Likewise, a Pillar 2 approach should not require disclosures based on standardized, Pillar 1 metrics. Disclosures based on any Pillar 1 approach could be confusing and misleading to the market. As discussed above, a Pillar 1 approach could result in different interest rate risk measures than a bank's internal measures under a Pillar 2 process. Investors may not understand the differences between the two, and it may be difficult for a bank to explain the differences without divulging proprietary information or confidential supervisory information. For instance, explaining the difference between the Pillar 1 framework for NMDs and a bank's own NMD estimates could require discussion of the bank's models, assumptions and projections regarding the future interest rate environment, and resulting changes in pricing—all of which may be based on confidential feedback from supervisors or proprietary market analysis.

And as discussed above, banks could have an incentive to manage to the Pillar 1 measure to provide more favorable regulatory disclosures, even though interest rate risk management based on an inaccurate Pillar 1 measure could actually increase risk.

²¹ See *id.* at 53-55 (Principle 10 and Principle 12).

B. Credit Spread Risk in the Banking Book

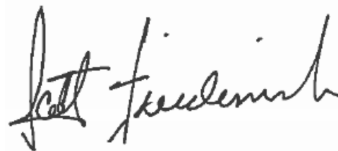
The IRRBB Consultative Document includes a vague concept of credit spread risk in the banking book (“CSRBB”).²² It is unclear whether CSRBB is part of IRRBB or a separate concept, and the scope of CSRBB.

To the extent the BCBS seeks to include CSRBB in the Pillar 2 approach, BNY Mellon urges flexibility for each bank to determine CSRBB based on its own profile and subject to robust supervision, consistent with a pure Pillar 2 approach.

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BNY Mellon appreciates the opportunity to respond to the IRRBB Consultative Document. We would be pleased to work further with members of the BCBS to discuss these comments and any other issues to better develop an IRRBB framework. Should you have any questions, please contact Eli Peterson, Managing Director, at (202) 624-7925 or eli.peterson@bnymellon.com.

Sincerely,

A handwritten signature in black ink, appearing to read "Scott Freidenrich". The signature is fluid and cursive, with the first name "Scott" written more compactly than the last name "Freidenrich".

Scott Freidenrich
Executive Vice President and Treasurer

²² See *id.* at 36-37.