

September 14, 2015

Mr. Jakob Lund
Mr. Toshio Tsuiki
Co-Chairs, Task Force on Interest Rate Risk in the Banking Book (TFIR)
Basel Committee on Banking Supervision
Centralbahnplatz 2
Basel, Switzerland

Dear Mr. Lund and Mr. Tsuiki:

**Re: CBA¹ comments on BCBS Consultative Document on Interest rate risk
in the banking book**

The Canadian Bankers Association (CBA) is pleased to provide its comments on the BCBS's consultative document: Interest rate risk in the banking book (IRRBB). In this response, we express our strong concerns over the BCBS's proposals and provide our view on what we believe would be a more appropriate supervisory framework for IRRBB.

IRRBB management practices vary widely across banks and jurisdictions – as they should – to reflect the unique risks faced by each financial institution with respect to their product offerings, distribution channels, customer behaviour, and other factors across lending and deposit products. We do not believe that it is practical or desirable for regulators to try to capture IRRBB through a “one size fits all” Pillar 1 approach.

While we acknowledge that a standardized approach is used in banking regulation for other risk types, we believe that failed attempts by regulators to develop a standardized approach for IRRBB in the past are indicative of the fact that IRRBB does not lend itself to standardization. Additionally, banks manage their IRRBB over long horizons, managing considerations related to economic value as well as earnings. By contrast, the BCBS's gone concern approach would incent banks to put more focus on economic value, leading to increased earnings volatility. It is for these – and other – reasons that will be detailed further in this letter, that the CBA strongly opposes a Pillar 1 approach to IRRBB.

¹ The Canadian Bankers Association works on behalf of 60 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 280,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness. www.cba.ca.

Overall, we believe that the consultative document attempts to address IRRBB in an overly simplistic manner, with the following main adverse impacts:

- While Canadian banks do not have material interest rate risk, the framework for non-maturity deposits severely reduces the value of all non-maturity deposits for Canadian banks. This will affect directly the nature of deposits, and indirectly lending markets in Canada, along with increasing bank earnings risk.
- Modelling own equity with zero duration will also lead to increased earnings risk for banks.
- The framework does not incent institutions to increase their risk management capabilities, as the framework does not recognize differentiating factors such as the quality of models, analysis, or risk management capabilities.
- As currently specified, the proposed model is not calibrated to any specified risk level. This leads to different capital requirements for similar positions held in the banking or trading book, and as a result, incomparability across institutions or jurisdictions.
- The proposed Pillar 1 approach would inappropriately increase the amount of interest rate risk assumed by borrowers.

We outline these, and other, concerns in greater detail below.

Non-Maturity Deposits

As structured, the consultative document doesn't identify carry trades. We understand that one of the main goals of the BCBS's proposals is to capture and properly capitalize carry trades (borrowing short-term and lending long-term) in the banking book. The primary concern with carry trades is that when interest rates rise there will be compression in margins as the rate paid for funding rises while the rate earned on assets may stay constant or increase very little. This could lead to variability in earnings, and possibly negative earnings, as the rate paid could exceed the rate earned. While the CBA recognizes that these events could threaten the soundness of an institution, the consultative document doesn't identify carry trades which should be capitalized.

In considering the effectiveness of a proposed model, some important distinctions need to be made. In particular, the nature of deposits is a key consideration:

1. Wholesale funding – At one end of the spectrum are wholesale floating rate deposits. Rising short-term rates will lead to higher funding costs. If these deposits are used to back long-term fixed rate investments, then a drop in earnings (or negative earnings) will result. At this point, the institution must choose to either hold the position and face the earnings volatility, or exit via hedging or by selling the asset (if a market exists for it) to pay off the funding. Higher rates will result in reduced or potentially negative margins for carry trades.
2. Other floating rate deposit products – Other floating rate deposits include deposits in which the rate paid is directly or indirectly linked to short term market rates. These present similar concerns to #1 above, although there may be some behavioural

considerations as well. One such factor is that the deposit pricing rate may be administered with a lag to market rates, with no adverse impact on balances. Second,

these products may be linked to other services offered to the client; access to these services may act as a deterrent to clients withdrawing balances in direct response to product rate changes that lag changes in market rates.

3. Zero or low cost funding – These products are a key source of funding for many banks. Banks offer a suite of services with the product (e.g., cheque writing privileges, ATM withdrawals, payroll deposit, pre-authorized bill payments, overdraft protection, etc.). The rate paid on the product is not a key feature of the product, and as a result the rate paid on these deposits may be zero or near zero with no impact to balance retention. These deposits are therefore fixed rate non-maturity deposit liabilities. Unlike #1 and #2 above, using these deposits to fund fixed rate assets does not give rise to carry trade problems outlined above.

The spread earned on this position will be equal to the difference between the asset yield and the product rate of 0%. It will not vary as market rates change, until the point where the asset matures and a new asset is purchased. Moreover, it will never be negative provided investable asset yields are positive.

4. Partially rate sensitive products – These can be modeled as a blend of #2 and #3 above. For purposes of interest rate modelling, a portion of the balances would be modelled similar to #3 and a portion similar to #2.

The CBA does not believe that the BCBS's proposals achieve the goal of identifying positions which can lead to losses since it does not adequately differentiate the nature of each type of deposit described above. We believe that the proposed constraints on deposit modelling are punitive and would materially affect the value of deposits. This, in turn, would adversely impact the maturity transformation role that banks provide in each jurisdiction

The CBA does not support the implementation of arbitrary stability caps and pass-through floors for non-maturity deposit modelling. Rather, we favour reliance on robust methodologies and statistical analysis of client behaviours.

Equity

We believe that equity serves as a long-term source of funding for banks. Similar to core deposits, equity is permanent and not rate sensitive. As a result, investment of these funds in longer-term fixed assets stabilizes interest income and does not equate to a carry trade.

We do not believe that the proposed restriction on equity duration of zero is appropriate. An equity duration of zero would equate the interest rate risk associated with equity to that of floating rate wholesale funding as described above, when in fact from an interest rate risk management perspective equity has the highest core value. The proposed equity duration of zero will lead to increased interest rate sensitivity in bank earnings and will have the perverse outcome of increasing earnings risk at banks with stronger capital positions (assuming the same hedging practices).

Incentives to Better Measure and Manage IRRBB

The CBA believes that the regulatory framework should encourage banks to improve their risk measurement and management capabilities.

We believe that the BCBS's proposals do not incent institutions to develop a stronger understanding of their products since such analysis would not reduce capital requirements. The proposed Pillar 1 approach (or a standardized approach under Pillar 2) would not give any consideration to important differentiators in how banks manage (or should manage) IRRBB. This includes the frequency of internal measurement/management decisions, sophistication regarding hedging strategies (including dynamic risk management), and robustness of internal models/approaches for behavioral options.

Calibration of Interest Rate Shock Scenarios

The CBA is concerned that the interest rate shock proposals contained in the consultative document are not probabilistically calibrated and would create a divergence with the capital calculation approach used in the Fundamental Review of the Trading Book. We believe that interest rate shock scenarios applicable to measuring value risk should be probabilistically calibrated, with consideration for each institution's specific risk measurement frequency and hedging practices.

Combined with the 'static' view of the balance sheet (which does not reflect rebalancing), the shocks are too large for institutions that have dynamic risk management frameworks.

The BCBS's proposals do not take into account local volatility of interest rates and crudely aggregates interest rates in different currencies to arrive at a set of standardized stress scenarios. The averaging process underestimates the risk in jurisdictions with high volatility and overestimates the same risk for jurisdictions with low volatility.

Moreover, the lack of a calibrated approach for shocks results in variation of risk over time due to changes in the level of interest rates (i.e., higher rates will lead to higher capital for an identical risk exposure).

Impacts on Borrowers

The CBA believes that the BCBS's Pillar 1 proposal would reduce the availability of fixed rate funding and/or increase its cost due to the constraints on non-maturity deposits and equity. Consequently, we are concerned that the amount of bank funding available to support fixed rate lending would decline substantially under this approach.

As Canadian banks would need to retain a substantial portion of this risk, fixed lending rates would need to increase to accommodate the new interest rate risk capital charge, which would inevitably increase the number of borrowers selecting a variable rate, and hence imprudently increase the amount of interest rate risk taken on by retail and small business borrowers.

Other Concerns

Inclusion of Margins in Capital Calculation

The proposed IRRBB framework incorporates product margins in capital calculations which would imply that institutions with better margins would require higher capital buffers. In order to reduce this additional capital charge, banks would be required to "hedge" the margins, which would lead to higher earnings volatility. The hedge requirement and volatility would increase as interest rates increase and non-maturity deposit margins improve.

Market Implications

We believe that standardization of IRRBB measurement assumptions and practices would lead to significant crowding of Canadian banking book hedge activity and increased systemic risk and volatility in wholesale markets. Canadian wholesale markets have limited ability to absorb any material portion of the new banking book "risk" that would be created through the adoption of the proposed Pillar 1 approach.

The net effect of a Pillar 1 standardized approach would be a material infrastructure build to meet the framework requirements, while the results of these builds would not lead to an increased understanding of IRRBB, nor appropriate risk based capital.

CBA Supports a Pillar 2 Framework for IRRBB

The CBA supports a strong Pillar 2 approach for IRRBB that contains a comprehensive governance and oversight framework, sound risk measurement and management practices, enhanced regulatory reporting, and a meaningful approach towards identifying outlier banks.

These components of a strong IRRBB framework are largely covered by the enhanced Pillar 2 principles contained in the consultative document (Principles 1 through 7). The CBA also supports the implementation of a "standardized outlier test" (SOT) that would be applicable to internal measures of earnings and value risk; this would allow local regulators to apply additional scrutiny to such outliers. We would like to note our belief that risk should be defined as an economic or earnings loss, and not simply as a measure of variability. In addition, the CBA would also support tightened controls and requirements for IRRBB model validation under the Pillar 2 IRRBB.

While the CBA supports a Pillar 2 approach for IRRBB, we find the public disclosure requirements as proposed in the BCBS consultative document very problematic. In particular, we believe that many of the proposed disclosures would provide little, if any, value to investors, but would instead create confusion and misunderstanding in the market. In addition, behavioural assumptions and hedging strategies are commercially and competitively sensitive and should therefore not be disclosed publicly. Public disclosure of assumptions can be a disincentive to investing in driving forward assumption, measurement and methodology improvements, as any enhancement will be shared with competitors. This would also adversely affect product innovation, likely crowd the banks into similar assumptions over time, and increase systemic risk.

We oppose the proposed public disclosure of standardized framework risk measures as described in Principle 8 as it would misrepresent IRRBB risk in part due to application of scalar multipliers for behavioural option and implied caps on NMDs which are not consistent with the

Canadian experience, and will thus create confusion and misunderstanding in the market. We also believe that public disclosure of key assumptions has the unintended effect of increasing systemic risk as there may be an alignment of assumptions over time. This disclosure requirement would effectively act as a quasi-Pillar 1 approach that would give misleading information on risk (i.e., the standardized approach calculations may be improperly viewed by the market as being "correct"), versus more realistic internal risk measures and existing risk disclosures.

We also strongly oppose using any of the elements of the proposed Pillar 1 standardized calculation to identify outlier banks under Pillar 2 as described in Principle 12. Principle 4 acknowledges that internal models (and scenarios) should reflect each bank's unique risk profile, yet principle 12 relies on the standardized calculation to identify outlier banks.

In closing, the CBA supports the continuation of the Pillar 2 approach, one based on internal models, strong governance principles, a strengthened reporting framework, and early warning indicators to allow regulators identify outlier banks.

We would be pleased to discuss these comments with you further at your convenience.

Sincerely,

A handwritten signature in black ink, appearing to read "Daren Hamel". The signature is fluid and cursive, with the first name "Daren" and last name "Hamel" clearly distinguishable.

cc: Mark Zelmer, Deputy Superintendent, OSFI
Greg Caldwell, Capital Specialist, OSFI