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Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

September 10, 2015

Re: BCBS Consultation on Interest rate in the banking book

Dear Sir/Madam,

China Banking Association (“CBA”) appreciates the opportunity to comment on the Basel Committee on Banking Supervision Consultative Document: Interest rate in the banking book dated June 2015.

China Banking Association (CBA) is a nationwide non-profit self-discipline organization of China’s banking sector. CBA serves for the common interest of its members through the functions of self-discipline, rights protection, coordination and service so as to safeguard lawful rights and maintain market order of the banking sector, and promote the healthy and sustainable development of the industry. By May 2015, CBA has 378 members and 4 observers.

We greatly appreciate the great endeavor you have made to review and improve the regulatory treatment of interest rate risk in the banking book to help ensure banks have appropriate capital to cover potential losses from exposures to changes in interest rates and to limit capital arbitrage between the trading book and the banking book, as well as

the opportunities you have provided to solicit the industry's comments on the 2 proposed approaches for the capital treatment of interest rate risk in the banking book.

On this important topic, we therefore have solicited member banks' main comments as below for your reference, which we hope can be helpful. And we sincerely appreciate the great endeavor you have made in the global financial regulatory reforms.

Yours sincerely,

A handwritten signature in black ink, reading "Yang Zaiping". The signature is written in a cursive, flowing style with some ink bleed-through from the reverse side of the paper.

Yang Zaiping

Executive Vice President

China Banking Association

General Comments

Suggest applying enhanced Pillar 2 approach to manage interest rate risk in the banking book

We believe that the enhanced Pillar 2 approach proposed by BCBS is more reasonable for below considerations:

1. There are many differences in terms of interest rate environments, interest rate risk characteristics and financial product features in different countries. The enhanced Pillar 2 approach encourages regulators and banks to develop customized risk evaluation methods and is more suitable to capture and evaluate the multi-dimensional IRRBB risk management dynamic than a standardized Pillar 1 approach;
2. The enhanced Pillar 2 approach with higher requirements of risk management and information disclosure could improve the existing regulatory regime, and we think the risk management of IRRBB is as important as capital requirement for the banks.

Specific Comments

I. Comments on Cash flow bucketing & Interest rate shock scenario design

1. Comments on Cash flow bucketing

1.1 Supplement the detailed requirements about OBS exposures

Basel committee (Hereinafter as “the committee”) has mentioned how interest rate options and fixed rate commitments should be measured in the Consultative Document. We recommend the committee to further clarify whether derivatives (e.g. IRS, FX Swap and CIRS) or other OBS products with implied revenue commitment should be measured. And we also recommend the committee to provide the measurement requirements for these products, for example, should derivatives be measured for both of their notional principle and interest cash flows?

1.2 Improve the measurement method for credit spread components

Many deposits and loans are priced with fixed multiplier rather than fixed credit spreads, which results in that the spread components will change with the benchmark rates fluctuation. Therefore, it is suggested that the committee could make further explanation and improvement in the measurement method for the credit spread components of floating rate priced instruments. And we recommend that the classification approach of such interest cash flows could be the same as their principals', i.e. they are assumed to be repriced fully at the first reset date.

2. Comments on Interest rate shock scenario design

2.1 Strengthen the local regulator's discretions

Interest rate environments are very different in different countries and the interest rate transmission mechanism, approach and effect are different. Uniform interest rate shock scenario is helpful to compare between different countries and to promote fair competition but not conducive to reflect the different interest rate risks conditions among different countries and regions. So it's recommended to strengthen the local regulator's discretions based on the methodology guidance of interest rate shock scenario, including allowing the application of multiple yield curves with local regulators' approval in regions with unaccomplished interest rate liberalization reform to reflect the risk characteristics of different business, setting interest rate shock and make regular update.

2.2 Adjust the formulas for interest rate shock scenarios

2.2.1 There are mistakes in the interest rate shock scenarios formulas in the CD and we recommend the committee to review and correct them. For example, in the formula $\Delta R_{j,c} = \bar{R}_c(t_k) \cdot \bar{\alpha}_j \cdot S_j(t_k)$ on page 15 in the CD, the local current rates $\bar{R}_c(t_k)$ are dependent on time bucket midpoint. And it will generate unparallel interest rate shocks when determining parallel shock scenarios using the formula above. We recommend to use $\bar{R}_{j,c}$ instead of $\bar{R}_c(t_k)$ and $\bar{R}_{j,c}$ is the average value of all rates under interest rate shock scenario representation in currency c and not dependent on time bucket midpoint.

2.2.2 Caps and floors are applied after using scalar in the Consultative Document and it may generate parallel shocks when determining short rate shock scenarios in a low

interest rate environment. We recommend to apply caps and floors before using scalars.

2.3 Provide detailed explanations for the interest rate shock scenario design

We recommend the committee to provide detailed explanations for the interest rate shock scenario design and the parameters, such as selection of yield curves, length of historical data serials, methods and standards for determining and updating the parameters etc. This will help banks to fully understand the rationality and periodical updating mechanism of the interest rate shock scenario design in the Consultative Document and a detailed example will be welcomed.

II. Comments on Non-Maturity Deposits (NMDs)

1. Comments on classification of the deposit type

1.1 In the consultative document, the stable NMD portion is the portion that is found to remain undrawn with a high degree of likelihood. However, it is hard to distinguish between stable and non-stable portion according to this definition, and more specific standards need to be provided. Besides, it's also necessary to clarify the difference and relation between the definition of stable/non-stable in NMD and those in liquidity regulatory standards.

1.2 In Time Series Approach (TIA), it is required to use observed volume changes over the past 10 years to distinguish between the stable and non-stable parts of NMDs. Since 10 years historical data may have low relation with nowadays costumers' behavior, we suggest that a data set covering a complete economic cycle is enough.

1.3 Since it is hard to distinguish between stable and non-stable parts and it is difficult to evaluate pass-through rate, is it more rational to use model to evaluate core and non-core deposit parts directly without distinguishing stable and non-stable parts?

1.4 In Time Series Approach (TIA), it is said that "The categorization of a deposit as transactional thus relies exclusively on qualitative criteria. Banks must apply their own criteria based on historical data or local/business model features. Such a proposed

approach is intended to allow for a certain degree of recognition of local conditions, but is subject to supervisory review and approval.” It’s suggested to provide more specific standard to distinguish between transactional and non-transactional parts of retail deposit as well as the difference and relation between the definition of transactional/non-transactional in NMD and those in liquidity regulatory standards.

2. Comments on the treatment and parameters of NMD

2.1 Pass-through rate is difficult to evaluate based on the definition in the consultative document, and it’s suggested to provide more explicit evaluation methodology.

2.2 It’s suggested to provide the calculation process of NMDs parameters, including:

- a. In Time Series Approach, the Stability cap, Pass-through rate floor and implied cap on core NMDs.
- b. In Simple Time Series Approach (STIA), it sets out the value of retail and wholesale deposit percentage cap and interval division value in the calculation of proportion of NMD currency equivalent amounts eligible to core NMDs. It should take a second thought of whether those values are reasonable.

Different countries’ customers may respond differently to interest rate change of NMDs since there are great differences on depositors’ behavior characteristics, deposit account features and the abundance of financial products among different countries. Because of this, those parameters are suggested to beset by local supervisory based on local quantitative measurement results.

2.3 A transition period like 3-5 years before the implementation should be provided since it needs time to accumulate customer behavior analysis data and optimize quantitative measuring system.

3. Other Comments

Since each bank all over the world has non-maturity reserve against deposit, it’s

suggested to provide more specific treatments on such kind of reserve.

III. Comments on automatic options and customer behavioral options other than NMDs

1. According to the principle of importance and the real business situation of the bank, we suggest establishing an entry threshold for calculating the customer behavioral options other than NMDs.

For those positions subject to the three behavioral options risks other than NMDs, as a percentage of the bank's on-balance sheet and off-balance sheet positions, may be high/low compared to other business. If the proportion is low enough, we suggest a calculation exemption from the principle of importance. In practice, we could introduce an indicator for explaining the position proportion to total asset, when the indicator is lower than the threshold, the calculation for behavioral options could be exempted.

In some countries, say China, the percentage of medium and long-term fixed rate loan to loan portfolio is comparatively lower than other economies in the world. In addition, the interest rate of loan commitment is basically determined based on the benchmark rate at the time of commitment drawing and there is few fixed rate loan commitment.

2. We suggest the Basel Committee to consider clarifying explicitly that floating rate loan and floating rate loan commitment drawing are not included in the calculation for customer behavioral options.

The variance of present value of floating rate loan would be low under scenario of interest rate shock, given the repricing frequency is usually less than 1 year. Therefore, the interest rate risk of floating rate loan is not material.

3. We suggest the Basel Committee to grant local regulator the discretion for determining the parameters and scalars under Pillar 1 standardized approach. It's highly recommended to provide the definition of the CPR\PTR\TD RR and the specification and assumption of the relevant scalars under different rate shock scenarios, as well as the calculation process if Basel Committee has made the decision to employ relevant

scalars in the Consultative Document.

The scalars within the consulting paper are set for different interest rate shock scenario, implying that interest rate is the main risk factor of customer behavior, however in many cases, interest rate is not the major factor to cause the customer behavior, for example, the maturity is a more significant driver influencing the likelihood of loan prepayment. Hence, in order to consider several risk factors of customer behavior to the maximum extent, we suggest the Basel Committee to grant local regulator the discretions for determining the baseline estimates as well as the scalars under different rate shock scenario.

If Basel Committee has decided that the relevant scalars must be employed under the standardized approach, it's highly recommended to provide the definition of the CPR\PTR\TDRR and the specification and assumption of the scalars, as well as the calculation process so that bank could evaluate the applicability of such scalars.

4. It's inappropriate and too strict to slotting all the term deposits redeemed early into the "overnight" bucket. We suggest to adopt the solution same as the fixed rate loan prepayment, where the redeemed cash flow is adjusted to relevant time bucket k based on the notional outstanding at time bucket $k-1$.

The proposed cash flow treatment of term deposit redemption will lead to the repricing mismatch of asset and liability being enlarged intentionally, causing interest rate risk overstated. Therefore, we suggest to adopt the solution same as the fixed rate loan prepayment, where the redeemed cash flow is adjusted to relevant time bucket k based on the notional outstanding at time bucket $k-1$.

5. It's necessary to upgrade or reconstruct the risk system to get with the needs of more complicated cash flow calculation for customer behavioral adjustment. Much time and manpower shall be invested to system optimization project, we suggest the Basel Committee to offer a grace period for the calculation of customer behavioral option, within which period the calculation is not compulsory.

6. According to the consulting paper, the standardized approach only applies to retail

customers. While the behavioral option of non-retail customers is included within the automatic option calculation. Separating the embedded or implicit option value from the instrument is prerequisite to apply the automatic option calculation. However, the behavioral option of non-retail customer is difficult to be stripped out and valued separately. We hope that the standardized approach could cover the non-retail customer. In practice, it's feasible to set up differentiated scalars for retail and non-retail customer to reveal the behavioral difference.

7. In the last paragraph of page 29 of consulting paper, say “any changes in market values associated with those bought automatic interest rate options not used for hedging sold automatic interest rate options must be added to the KAO”, we hope that Basel Committee could elaborate how to add the changes of bought option to the KAO and a detailed illustration is highly welcomed.

IV. Comments on EVE, NII, basis risk and minimum capital requirements

1. Comments on the general earnings-based (NII) measure (II-4.2, P31)

1.1 In order to improve the consistency of the measurement, we suggest that the time range T should be clearly defined as one year.

1.2 In simplified NMD calculation, we suggest an additional method to be considered: We suggest that banks can set discount factors to particular positions like NMD according to their actual situations. For example, in Scenario 1 or 2 (parallel shift), banks can set a discount factor of 0.1 to demand deposits, to reduce its interest rate sensitivity.

2. Comments on the reference rate basis risk (II-4.3,P32)

In order to stay in line with the method of general NII measure, we suggest that the reference rate basis risk measure should also consider the discount factor.

3. Comments on short-term non-parallel gap risk (II-4.3,P33)

In the given formula, X and Y are expressed as the different reset frequency on the same reference rate curve. And RR in the formula represents the number of reference rate

curves. There are contradictions between them. We suggest that the formula should be checked and a calculation example should be given. We consider that the correct formula might be:

$$\Delta NII_c^{npq} = \sum_{rf}^{RR} \sum_Y^{rf} \sum_X^Y \left(\min(\max(CF_{0,c,rr,rf_X}^*; 0); \min(CF_{0,c,rr,rf_Y}^*; 0)) + \min(\min(CF_{0,c,rr,rf_X}^*; 0); \max(CF_{0,c,rr,rf_Y}^*; 0)) \right) \bullet HS_{rr,rf_X,rf_Y}^c$$

4. Comments on the aggregation of currency (II-5.1, P34)

We suggest that the specific method for offsetting the parameter w should be provided.

5. Comments on the formula of Option 2 (II-5.3, P35)

In the given formula, the parameter under the sum symbols may be NII, rather than EVE. We suggest that this formula should be checked.

6. Comments on the four options in the calculation of minimum capital requirements.

In the calculation of minimum capital requirements, the comprehensive consideration of EVE and NII is good for avoiding adverse incentives. Therefore, we suggest that option 3 or option 4, which is more reasonable, should be used. We also suggest that the calculation of NIP should be more detailed and a particular example should be provided.

V. Comments on the Enhanced Pillar 2 Approach—Banks' Perspective

1. Set a transitional period for the enhanced pillar 2 approach when implementing IRRBB management.

In the enhanced pillar 2 framework, data accumulated from interest rate liberalization is insufficient in countries where the interest rate liberalization hasn't accomplished. In addition, to implement the new regulation criteria, systems, staff and data in commercial banks all need large amendment and transformation. Therefore, we propose setting a 3-5 years transitional period for the implementation of enhanced pillar 2 framework and gradually reaching the target.

2. Grant greater discretions for local regulators and allow local regulators to make appropriate revision based on the market situation.

In the risk measurement and monitoring principles under the enhanced pillar 2

framework, the qualitative measurement requirement is from the section II (the Pillar 1 approach) in Consultative Document. So we recommend when implementing the enhanced pillar 2 approach, it should be different from those strict requirements in pillar 1 approach. Local regulators should be provided greater discretions to make appropriate revision for the selections of yield curves, assumptions and parameters settlement of behavior models, setting of shock scenarios and formula of capital provision.

3. Simplify the public information disclosure for the model parameters and assumptions involved business secrets

In the public information disclosure, the behavior parameters such as TDRR, CPR, PTR required in the enhanced pillar 2 approach involve business secrets of commercial banks. Therefore, we suggest simplifying the qualitative information disclosure to the definition, strategy and ideas of setting the parameters.

4. Specify the validation criteria of IRRBB models or the key parameters in models with focus on verifying customer behaviors.

According to the bank principle 6 in the enhanced pillar 2 approach, all of the models used for IRRBB management need verification. The verification approach should include but are not limited to the third-party and backtesting methods. Since the IRRBB mixes with other risks, it's difficult to clearly extract the interest rate risk and use independent backtesting to verify IRRBB. These may result in inaccurate evaluation results. We suggest the Committee to provide specific validation criteria and methods. Moreover, the quantitative outcomes for NII and EVE are mainly influenced by operating strategies such as business volume assumptions and interest rate trend assumptions. We recommend the focus of verifying the models could be the behavioral key parameters, such as stability of deposits, pass-through rates and early redemption.

5. Specify the hedging strategies for IRRBB, the application of IRRBB hedging instruments and the treatment principles for transactions like Macro-arbitrage.

To improve the IRRBB management of banking institutions, we propose adding principles in terms of hedging strategies for IRRBB and the application of IRRBB

hedging instruments.

VI. Comments on the Enhanced Pillar 2 approach---Regulators' Perspective

1. The Consultative Document requires that the bank should use standard interest rate shock scenarios to measure IRRBB and report the results to the regulators. It is too strict and doesn't conform to Pillar 2 approach or interest rate market features of different countries. The interest rate shock parameters and customer behaviors assumptions under the standard scenarios are based on the mature markets, which have not been proved to be suitable to the emerging markets.

Suggestions:

Do not require the standard interest rate shock scenarios as a mandatory measurement and give certain discretions to local regulators who could construct the local interest rate shock scenarios with reference to the standard shock scenario. The local regulators should be able to clarify the relationship between the local scenarios and the standard scenarios set by the Committee and are able to make adjustments to the parameters and assumptions in the standard shock scenario based on own interest rate market's feature if the regulatory authority adopted the standard shock scenario.

2. The IRRBB should be included in the ICAAP and take the diversification effects into account, which is different with the Pillar 1.

Suggestions:

Highlight the relationship between IRRBB and ICAAP in the regulatory principles and take the capital requirement under Pillar 2 into full consideration.

3. As the interest rate market environment and the bank balance sheet structure differ from country to country, it will not be suitable to set a global uniform threshold for judging the outliers.

Suggestion:

For the threshold of outliers (accounted for the economic value of equity (Δ EVE) as a proportion of Common equity Tier 1 (CET1) or Tier 1), we suggest that we should give certain discretions to local regulators. Meanwhile, the cliff effect and regulatory arbitrage arising from threshold setting should be given considerations, so the outliers should also include the bank whose risk management ability can't match its risk exposures.

4. For identification of outliers, it's difficult to master the judgment standard whether the bank could obtain enough income to maintain its normal operation. Meanwhile, different from economic values, the bank's profitability reflects the income within a period of time in the future and is closely connected with the change of the assets and liabilities structure. It is difficult to make accurate measurement in static situation, and also doesn't conform to the commercial banks' business practices.

Suggestion:

We suggest not remaining the judgment associated with profitability for outliers in, It could be made clear in the principle that regulators should combine the earnings volatility under different interest rate shock scenarios with the bank's ICAAP and capital planning to make comprehensive judgment on the changing trend of bank's future capital levels under different stress scenarios.