

CREDIT AGRICOLE's response to the proposed changes to the regulatory capital treatment and supervision of IRRBB

BCBS's Consultation Paper, 11th September 2015

CREDIT AGRICOLE is a mutual banking group with a strong presence in retail banking in France. The regional Bank network in France provides banking services to individual customers, farmers, small businesses, SMEs and local authorities, with strong local roots. LCL is a French retail banking network with a strong presence in urban areas. CREDIT AGRICOLE has also a substantial presence in retail banking in Europe, particularly in Italy and Poland. The Group's penetration rates in France are above 30% for individual customers, 90% for farmers, 35% for small businesses and SMEs.

The CREDIT AGRICOLE retail networks in France and in some other EU Member States provide a full range of banking and financial products and services: savings products, life insurance investment products, lending (namely home and consumer finance, loans to corporates, small businesses and farmers), payment instruments, personal services, banking-related services and wealth management.

Given our group's business model (collect deposits, loan granting to retail and corporate clients), asset and liability management of interest rate risk is a key feature of the retail banking's robustness and profit stability.

In this context, CREDIT AGRICOLE GROUP highly appreciates the opportunity to provide the BCBS with its comments on the changes to the regulatory capital treatment and supervision of IRRBB.

Focusing on what we think are the most important issues, our concerns relate to the unintended consequences which could result from the proposed standardised regulatory framework:

- **Increased IRRBB exposure** resulting from a move of banks towards hedging strategies which would minimize capital requirement based on the prescribed standardised methodology rather than on the effective banks' exposure to IRR.
- **Increased difficulties to raise market resources** resulting from higher earnings volatility, notably in a stressed environment.
- **Increased credit risks** as the proposed changes set out in the Consultative Document are a clear incentive to shift the product mix towards variable rate loans, with greater uncertainties as regards the borrowers' solvency. As a reminder, one of the triggers of the 2007 financial crisis was the increase in repayment annuities on subprime variable-rate mortgage loans.
- **Undermined real-estate market.** In some jurisdictions, retail borrowers are reluctant to borrow at variable-rates. If banks shift their offer towards variable-rate loans, this may lead to a reduction in credit demand.
- **Swap market disruption during the implementation phase.** As the prescribed standardised methodology differs to a great extent from the current banks' risk assessment, the volume of derivatives transactions necessary to modify the IRR profile is large in comparison to the current swap market liquidity. This may lead to heightened volatility in market rates, all the more since the banks' hedging needs would be easier to anticipate by market participants.

PILLAR 1 VS PILLAR 2: The necessary standardisation of Pillar 1 metrics is not suitable for IRRBB

The capital charge against IRRBB cannot be standardised because there is no exclusive strategy for reducing risk

For most (if not all) risks subject to regulatory requirements under Pillar 1, an overall risk mitigating strategy can be defined. Credit risk can be lessened if a bank reduces its exposure to borrowers with low credit profiles and if it strengthens its credit origination standards by requiring credit risk mitigants of a higher quality. The VaR for market risk can be reduced through an effective hedging strategy. Under the advanced modelling approach, a bank's operational risk exposure can be lessened through the use of eligible insurance techniques. Such an overall risk reduction strategy can also be defined for liquidity risk, which can be mitigated by extending the maturities of fixed-term liabilities.

For all those risk natures, unquestionable risk mitigating strategies make it possible to define standardised rules for solvency or liquidity purposes.

As regards IRRBB, the asset and liabilities repricing profile should be properly determined and matched in accordance with an in-depth analysis of the customers' behaviours and of the bank's competitive and regulatory environments (including national regulations on deposits, where appropriate). It is particularly worth noting that, as far as interest-rate risk is concerned, having longer or shorter fixed rate resources does not necessarily equate with less or more prudent risk management. Any standardised model with constraints on behavioural analysis would unquestionably distort the IRRBB measurement without clearly reducing risk as it is the case for other risk natures.

By excluding equity and by capping the 'maturity' of Non-Maturity Deposits, it is clearly assumed in the CP that the shortening of assets' maturity would help reducing a bank's exposure to IRRBB, whatever the features of its liabilities. But banks which would have invested their retail deposits resources in short-term assets according to that assumption would struggle in maintaining adequate operating profit margins in the current environment, for example due to a low pass-through rate for retail deposits¹. The approach implies that banks may fully benefit from lower swap rate whatever the pass through rate on retail deposits, ultimately by raising market funding. However, according to us, it would not be advisable to induce banks to largely rely on market resources to fund their retail assets.

The regulatory environment on retail deposits is particularly heterogeneous, resulting in IRR profiles which cannot be standardised.

The retail deposits make up the cornerstone of the supply of financing to the economy. In many jurisdictions, governments incentivise retail investors to use saving products with regulated interest-rates or tax incentives mechanisms. As an illustration, in some jurisdictions, individual depositors may benefit from a fixed interest rate during an extended period of time on certain regulated deposits, even in a low rate environment. This makes it necessary for banks to hedge on a long-term basis. As a result, any attempt to standardise and constraint behavioural analysis would disregard those local specificities and may give a false assessment of a bank's exposure to IRR.

¹ Typically, only a portion of the decline in IR on saving products can be passed on to clients in France where interest rates paid on retail deposits are largely regulated: interest rate paid on French Livret A/LDD currently stands at 0.75% (OA: 330b€) and new opened French Plan d'Epargne Logement bear a 2% IR (OA 230b€).

Those issues have been considered by the EBA in its guidelines on the management of IR which state that *“it is for this reason that IRRBB is part of Pillar 2, where a tailored approach is possible”*.

Standardised rules should not have any automatic implications for capital requirement which may encourage banks' management to wrongly change their risk management approach. Moreover, we are of the view that the outcomes of the standardised calculations should not be publicly disclosed as it may give wrong indications on the actual bank's exposure to IRRBB.

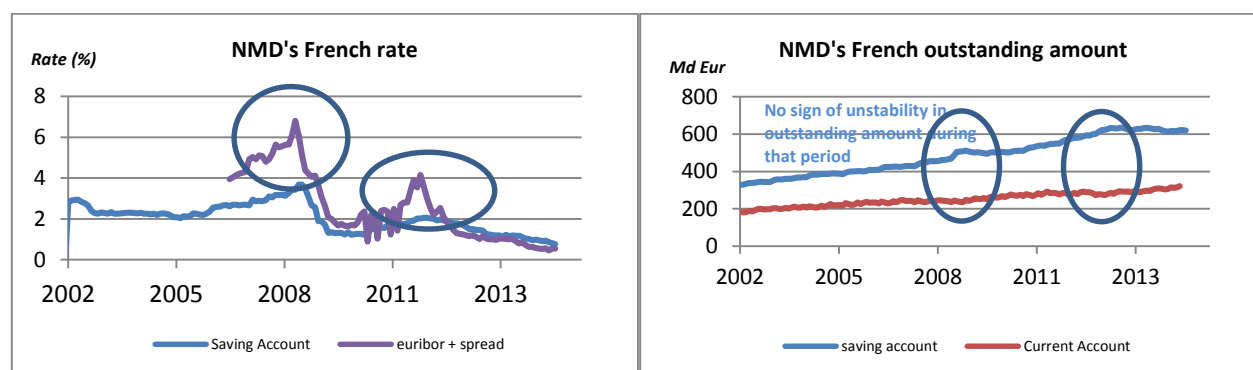
MODELLING ASSUMPTIONS

- **Non Maturity Deposits**

We believe that the proposed standardisation approach on Non-Maturity Deposits is not appropriate and that the proposed cap to be applied on the average maturity may actually increase the interest risk borne by banks on certain deposits.

We do not think that the shortening of the amortising replicating model is systemically a prudent approach for the management of interest-rate risk. Indeed, the use of the Economic Value of Equity (EVE) as the baseline indicator for assessing IRRBB can be misleading as it disregards the interest rate risk borne by a bank beyond the convention-horizon. The use of short-term models appears to be artificially and wrongly prudent and it would give an inadequate sense of comfort just because it would reduce the horizon over which risks are actually analysed. This ignores the risk for a bank of having insufficient margin beyond the model horizon to cover its operating costs and its credit risk.

Moreover, banks have been exposed to extreme stressed conditions on deposits during the liquidity crisis. The liquidity shortage and the sharp increase in credit spreads should have been a strong incentive for banks to fight for deposits. However, the yield paid on current accounts during that period in France has remained equal to zero and yields paid on saving deposits were well below the market funding costs hence displaying low elasticity characteristics. Even in this very low remuneration environment which could have been an incentive either for clients to move to better remunerated products or for banks lacking liquidity to offer more competitive products, the outstanding amounts on NMDs (non-interest bearing current account and saving deposits) have remained very stable.



The French banks resort to long-term models for these deposits, in line with their very low elasticity to market rates and their strong stability, even in a stressed environment. Those models have softened the decline in interest rates and because the pace of decline in the net interest margin rate has been slow, banks were actually able to adapt their fee structure to maintain their operating profit margins. On the contrary, if banks had been required to use a short-term model as proposed in the BCBS' consultative paper, the net interest margin would have sharply fallen and banks would have had to cope with increased difficulties in adapting their business model and in maintaining appropriate operating profit margins to cover their credit losses, operating costs and return on equity capital or to pay interests on low pass-through rate deposits.

- **Investment of Equity**

Assuming that equity capital is invested over the short-term increases exposure to IRRBB even from a gone concern perspective

- ✓ We are of the view that equity capital being available to absorb losses (mainly credit losses for retail and commercial banking), it should not be considered as being invested over the short-term. Indeed, in case of loan losses, the bank actually loses a portion of its fixed-rate assets. If, as set out in the BCBS's proposal, those loans are assumed to be 100% matched with fixed-rate liabilities, the bank would then be exposed to an interest-rate mismatch following a credit write-off, since part of its fixed-rate liabilities may not be matched any more with its fixed-rate assets. Moreover, as credit losses tend to increase in a stressed macro-economic environment which is usually associated with a decline in interest-rates, a bank would then be exposed to interest-rate losses on top of having to deal with increased credit losses since its unmatched fixed-rate liabilities would then be above the current market rates and hedged with an IR loss.

If, as it is our view, the duration of a bank's equity capital is at least equivalent to the duration of its credit portfolio, the decrease in assets duration is then equivalent to the decrease in its liabilities duration after a portion of its equity capital has absorbed its potential credit losses.

- ✓ In case of resolution, capital would be reconstituted through TLAC's debt write-down which gives stability to this resource even in an extreme stress case.
- ✓ Investing Equity over the short term would add cyclicalities to revenues with a negative impact of a decline in interest rate which usually takes place in stressed economic conditions.

- **Behavioural Risk**

We believe that the proposed standardisation approach on behavioural optionality is not appropriate

Behavioural optionality is a significant contributor to the banks' IRRBB. Consequently, the methodology to be applied in this area should properly reflect the specificities and the dynamics of those embedded options.

A stress on CPR (Conditional Prepayment Rates) should be applied only during the first two years as, in the worst case, clients would react within this timeframe in case of a decline in interest rates. Beyond this timeframe, the CPRs would return to their structural level. In addition, the scaling factor should be applied to the average historical prepayment rate (or the minimum as it is closer to the structural prepayment rate) and not the current estimations used by the bank as these may already have been stressed after a decline in interest rates.

As an alternative to standardised scaling factors which are not representative of product² specificities, we strongly recommend a more suitable methodology based on the minimum prepayment rate observed historically by a bank on the relevant portfolio over a two years period (for a parallel upward shock) or the maximum (for a parallel downward shock). The same methodology can be applied to term deposits subject to early redemption risk and to fixed-rate loans commitment.

- **Interest rate shock scenarios**

The proposed scenarios would result in artificially high volatile capital requirements

According to us, it is not appropriate to provide for shock scenarios that are proportional to the current level of interest-rates as specified in the consultative document. In the current low interest-rate environment, it would result in a shock equal to the floor (i.e. 100bp). However, in case of an increase in interest-rates, the required shocks would rise and may even reach the maximum of 300bp in case the market interest-rates would normalise. Such a model would result in particularly volatile capital requirements. We would therefore recommend implementing interest-rate shocks linked to the historical volatility on absolute change of interest rate (and not relative), hence which would not be proportionate to the current interest-rate levels.

CAPITAL REQUIREMENT

It would not be consistent to impose a capital charge against NII or EVE variability without taking its initial level into account

Contrary to the trading-book where future profits are accounted for instantaneously, future profits in the banking-book, in particular in retail banking, are accounted for on an accrued basis. Consequently, a capital charge that reflects the volatility of future profits is coherent with the trading-book activities, since in that case, the volatility of future profits is a relevant yardstick for losses impacting the solvency ratios. But, when it comes to the banking-book and especially to the retail banking where future profits are not accounted for, this would not be a relevant metric for future losses in relation to their actual impact on the solvency ratios.

Failing to do so, would lead to situations where a bank with very likely future losses under an IRRBB stress might be required to hold less capital than a bank with future profits which would very likely remain positive even under an IRBB stressed environment.

Capital requirement shall be based primarily on NII and EVE shall be limited to forward-looking stress to capture the static exposure to long-term transformation (i.e. beyond the simulation horizon).

As stated in the consultative document, the ALM's primary objective for most banks is to stabilise the future earnings. Moreover, earning-based measures are the most relevant indicators for all stakeholders:

- Stability in the net interest income of the banking-book is necessary to adequately cover the associated operating costs and the cost of risks and to allow for stable returns on equity.
- Debt and equity investors focus on quarterly earnings and would struggle to rely on an EVE metric since it is in a gone concern perspective (whereas all external financial analyses are in a going concern perspective).

² Typically, mortgage loans prepayment rate is much more sensitive to change in interest rates than consumer loans.

- The stress tests regularly conducted in various jurisdictions by Supervisors (such as the EBA/ECB's or CCAR stress-tests) are based on a projection of revenues on a multiple-year period in a stressed environment.

However, we understand the regulators' reluctance to base the IRRBB capital requirements on an earning-based approach exclusively: to determine assumptions on a long-term basis for the new production would indeed be full of pitfalls and, moreover, such a regulatory framework would disregard the long-term transformation position.

We believe that, in order to reach these two differing goals, i.e. to measure a bank's ability to effectively achieve stable earnings in line with its associated costs (i.e. operating costs and credit losses) and to capture its interest-rate exposure over the long-term, it would be advisable to introduce a "stressed capital assessment" factoring in a stressed 'terminal' EV (or 'forward looking EV') and the prospective NII on a reasonable medium-term horizon (4 years) after deducting the operating costs allocated to the banking book and the credit risk expected losses.

This proposal is expressed in the following formula: $MCR = \text{Max}(-\sum_{i=1}^4 NIP_i - \Delta EVE_f; 0)$

Where

- $NIP_i = NII_i \times \text{Cost to income ratio} - \text{EL}$ (for $i > 1$ as EL is already provisioned or deducted from capital for the first year)
- NII_i is calculated based on a stable balance-sheet assumption consistent with the supervisory stress-test assumption.
- ΔEVE_f is the forward-looking stress in EVE at the end of the 4-years stress period.

The stress on EVE should not take account of the impact of shocks in interest rates on the discounting of future margins. It would indeed artificially increase the capital requirement for banks with stable revenue and would incentivise banks to hedge the discounting effect on margins, which would not be consistent with their risk management and would also be challenging to include in hedge accounting.