

September 11, 2015

William Coen
Chair, Policy Development Group
Task Force on Interest Rate Risk
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Dear Mr Coen,

Consultative Document: Interest Rate Risk in the Banking Book (IRRBB)

1 DBS is pleased to have the opportunity to comment on the Basel Committee on Banking Supervision's (BCBS) consultative document on IRRBB. Our comments to the consultative document are attached at the Appendix to this letter.

2 We trust that our comments will be useful for the BCBS' further analytical work.

Yours faithfully,



CHNG SOK HUI
CHIEF FINANCIAL OFFICER
DBS BANK LTD

DBS' Feedback on the BCBS Consultation Document – Interest Rate Risk in the Banking Book

Summary of comments

We see several fundamental concerns on the proposal:

1. **Alignment of risk measures with the underlying business operating model:** The risk measures need to be aligned to how the business is managed. i.e., held-for-trading versus held-to-collect accrual income.
2. **Pillar 1 versus Pillar 2:** Pillar 1 assesses capital adequacy as at a point in time and does not incorporate future variability in capital supply (whether from NII or other sources). Conversely, Pillar 2 assesses the capital supply on a forward-looking basis. We are of the view that future capital supply volatility from NII variability falls within a Pillar 2 construct.
3. **Base level of NII:** If NII variability is to be taken into Pillar 2, the starting point should be the actual NII level, and not zero.
4. **Fair-valued positions in banking book:** The volatility in available-for-sale (AFS) interest rate-sensitive instruments, such as bonds, can largely be addressed by excluding the inclusion of mark-to-market gains in capital (i.e., reverting to the pre-Basel III stance).
5. **Additional potential arbitrage:** The potential arbitrage between banking and trading book is limited to fair-valued instruments in the banking book. There is no potential arbitrage for accrual-accounted instruments which are the bulk of the banking book.
6. **NMD stability is institutional-specific:** The actual pass-through rate varies significantly across banks and are thus better handled through an institution-specific Pillar 2 approach

1. Business model alignment

Fundamentally, the trading book is managed over a short-term horizon to profit from short-term fluctuations in the market. It is valued on a cost-to-close basis with risk-neutral priority. The assumptions behind the EVE approach are hence aligned with the trading book.

The banking book on the other hand is managed over a longer term horizon to collect accrual income. It is valued on a going-concern basis and the parameters are generally based on fundamentals e.g., physical probability of default. The EVE approach imposes strong assumptions on the banking book risk.

2. Pillar 1 versus Pillar 2

Pillar 1 measures capital adequacy in terms of the adequacy of capital supply to meet risk posed by a set of positions at a given reporting date. That risk may be articulated as the downside risk that would erode the capital supply. Therefore, from a capital adequacy perspective, the variability in banking book income due to changes in interest rates that is relevant is variability that results in a net loss that erodes capital supply measured at a given reporting date. Conversely, variability of income that does not result in a net loss would not be relevant.

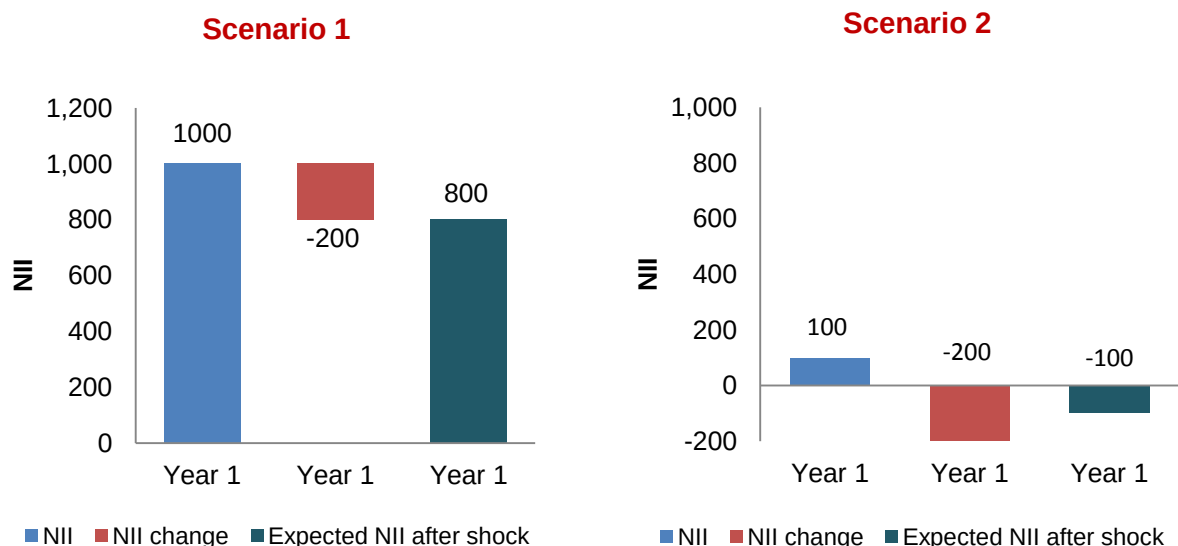
Pillar 2 has two purposes and it is important to distinguish them:

- a) To account for risks not captured under Pillar 1; and
- b) To assess future capital adequacy under a range of scenarios on a forward-looking basis; in this case the variability of banking book income is relevant for the stability of future capital supply and hence the capacity of a bank to continue meeting its capital adequacy objectives. Net interest income (NII) and NII variability measurements fit into future capital supply rather than a reporting date capital supply, and consequently should be dealt with under the Pillar 2 approach.

For traded interest rate risk, it manifests itself in the form of variability in income due to marking traded interest rate risk positions to market. Capital is then an appropriate buffer against potential losses as the unrealised profit and loss from marking to market is always included in income and hence in current capital supply for the capital adequacy measured as at a given date. In such a case, it is reasonable to set aside capital as a buffer against the risk of a diminution in the current capital supply, which is measured primarily in accounting terms, and for a Pillar 1 approach to apply.

3. Base level of NII

Other than Option 4, the proposals are indifferent to the degree to which future earnings variability may result in a net loss and hence deplete current capital supply. The following diagrams labelled Scenario 1 and 2 respectively are used to illustrate why it is not variability per se but variability relative to a base level of earnings that matters.



In **Scenario 1**, the expected change in NII is less than the expected NII

In **Scenario 2**, the expected change in NII is more than the expected NII

Both the projected NII and projected NII changes are based on the bank's expectations of earnings and profitability for a given profile of assets and liabilities in the banking book. The base level of projected NII is expected to add to its current capital supply over a given period of time. Under Scenario 1, the variability of NII is not likely to erode current capital supply. Therefore, a capital charge on the earnings variability per se is misguided.

In Scenario 2, the same amount of variability in NII could result in current capital supply being eroded and a corresponding capital requirement could be appropriate.

We acknowledge that 'Option 4' attempts to recognise the effect of underlying level of NII. While this is conceptually correct, there is still substantial work to be done to flesh out the framework described in Annex 3 in general terms. 'Option 2' and 'Option 3', on the other hand, use NII variability without considering the base level of NII and for this reason are not conceptually sound.

Nevertheless, we believe that even a full-fledged 'Option 4' proposal should not become the basis for a standardised capital requirement. The simulation of NII and its variability is highly dependent on market structure and entity characteristics, more so than other risk types. A standardised metric would be at best not meaningful, and possibly misleading. This is another reason for our assessment that IRRBB is more suitably addressed under Pillar 2.

4. Fair valued positions in the banking book

With respect to banking book bonds that are fair valued, such as AFS positions, a prudential filter that would remove the admission of mark-to market-gains as capital could be considered, i.e., to reverse the removal of the prudential filter under Basel III. Subjecting such positions to an IRRBB charge could be punitive as these positions may be held for prudential and/or liquidity purposes against the non-maturity deposits (i.e., high quality liquid assets and other jurisdiction-specific requirements) and, to that extent, would implicitly be largely funded by non-maturity deposits that are modelled to be long term.

We understand that one of the regulatory motivations for the removal of the pre-Basel III regulatory filter was the observation that banks have been filtering out mark-to-market losses on AFS bonds, although these could have resulted from a widening in credit spreads. This is admittedly a shortcoming, but the more optimal remedial measure is to ensure that banks undertake an assessment for a permanent impairment in such circumstances, and take the requisite impairment charges in earnings where applicable.

5. Additional potential arbitrage

The only incentives for capital arbitrage today are between fair-valued instruments in the trading book which attract interest rate risk charges and fair-valued instruments in the banking book that do not currently attract interest rate risk charges. There are no capital arbitrage opportunities with respect to accrual items, which can only be held in the banking book. Imposing a quasi-trading book EVE framework on accrual items in order to limit incentives for arbitrage is unnecessary as such arbitrage is not dominant in respect of such items.

6. NMD stability is institutional-specific

Key assumptions such as stability ratios and pass through rate leading to the calculation of core non-maturity deposits balances have the biggest impact on EVE and NII estimations. These parameters can be estimated from historical data and that forms the basis of the EVE estimates and NII projections.

The current proposals which offer partial flexibility but administer caps to stability ratios, maturity buckets of NMD time buckets and floors on pass through rate are not suitable for all countries. For instance, the market position of the bank relative to its competitors, the number of domestic systematically-important banks and the absolute level of interest rates are important determinants of these parameters. These factors, however, vary significantly across jurisdictions.

The proposed constraints can be contrary to what is reasonable for a given jurisdiction and experientially flawed. It may also result in a false sense of accuracy and comparability among investors as complexities in estimating these parameters are disregarded.

As such, each bank should be given full flexibility to measure all the relevant parameters including redeployment profiles of assets and liabilities. Such an approach has the added advantage that the metrics generated are in-use by management.