Brussels, 27th March 2024

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EACB comments on BCBS
Recalibration of shocks for interest rate risk in the banking book
(d561)

General comments

The EACB welcomes the opportunity to comment on the Basel Committee's *Recalibration of shocks for interest rate risk in the banking book*.

We agree with the intention to inform any final revision of the calibration with the results of a quantitative impact assessment. We believe that, on the basis of the results of the impact assessment, a successive consultation should be envisaged before finalizing the review.

Moving away from the use of global shock factors and introducing local shock factors

The interest rate shock scenarios should generally aim to ensure comparability between institutions at national and international level. We consider it sensible to link the interest rate shock scenarios to the interest rate level of the respective currency. The interest rate shock parameters derived for all currencies should correspond to the local currency and the underlying economic conditions (interest rate level, interest rate structure, inflation, mandate/powers of the central bank, money supply development, etc.). It should be noted that these parameters are fixed for several years. Significant differences in the level of the prescribed interest rate shocks could lead to distortions of competition.

In this context, it is also important to bear in mind that the adjustment of interest rate shocks has much further reaching consequences in some jurisdictions than in others, also in light of different implementations of the supervisory outlier test (SOT). The fact that the EUR shocks would increase quite sharply in comparison to other currencies would lead to multiple disadvantages for European banks. Incidentally, the institutions affected by the rates' increase had demonstrated good IRRBB management during the banking turmoil in 2023 and proved their resilience to interest rate shocks.

Furthermore, **the extremely coarse rounding to the nearest multiple of 50 basis points (bps) would lead to distortions** and contradicts the Committee's stated aim of making the calibration more precise and therefore more appropriate for individual circumstances. **We therefore call for rounding to a multiple of 25 bps**. This also corresponds to the customary adjustments of reference interest rates by central banks by 25 bps increments.

Adjustment of the time series: rolling vs pure extension

The derived interest rate shock parameters depend largely on the selected interest rate history (start/end time). With the change in methodology, the length of the interest rate time series would be extended from 16 to 23 years. Among other things, this change follows the simplified approach that longer time series would generally provide better forecast results. However, the methodology of time series analysis teaches us that **both statistical and external factors can have a significant influence**.

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For a continuously increasing time series, all interest rate changes for the given confidence level would always be used by construction. **Extreme events would be collected in the time series history and permanently influence the results, which would correspond to an extremely conservative approach**. In this case, extremely old information would possibly determine current and medium-term outlook. However, as time progresses, the information content of interest rate time series data for the simulation of interest rate shocks decreases.

Instead of opting for an ever-increasing time series, we would suggest adopting a **constant rolling time window of 20 years**. This approach would better recognise that the underlying economic reality is decisive, particularly for the risk-free interest rate time series that are relevant here. A time series length of 20 years generally includes several economic cycles and crisis-like developments. A further advantage of a constant time window is the review of the previous parameters in the sense of a robustness test. The signal to increase, hold constant or reduce the interest rate shock parameters is clearer.

The proposed methodology and time bound series appear to be penalizing for European banks. In light of the considerable increase in USD interest rates – also in comparison to EUR interest rates – and given the impact of IRRBB on US institutions, it would be hardly understandable why the parallel shock would move to 250 bps for EUR and remains at 200 bps for USD. The (unresolvable) arbitrariness in the selection of the history inevitably leads to distortions.

6 months moving time period

Members highlight that the rolling time interval of six months for determining the interest rate scenarios differs considerably from the period that is actually required to hedge or close out interest rate risks in the banking book, even in the event of an interest rate shock.

Instead, the open risk positions can be closed within a few days in accordance with management decisions. **A time window of six months for the simulation of an adverse interest rate structure acting overnight would be far too long and unsuitable in practice for a pure interest rate risk simulation**. The interest rate scenarios to be derived must be related to interest rate management. The result therefore represents an extreme scenario, which is not appropriate due to the high degree of conservatism and is not suitable for economic management. Stress tests are also carried out as part of the ICAAP so that crisis scenarios are also covered by institutions. An assumed adjustment pace of three months for the supervisory shock scenarios would be sufficiently conservative.

No need to increase the confidence level from 99% to 99.9%

The choice of confidence level has a significant influence on the size of the interest rate shock. Looking at the 16-year time frame (January 2007 to December 2022), the 99% percentile for the Eurozone would confirm a parallel shock of 200 bps, which would be matched also under the extended time window of the consultation paper.

We strongly advise against an increase in the confidence level from 99% to 99.9%. This results in extreme scenarios that are not suitable for adequately assessing the interest rate risks in the banking book on an ongoing basis. **The interest rate shock scenarios should continue to be differentiated from a "maximum drawdown", especially as institutions also perform internal stress tests**.

The proposed new interest rate shock parameters in EUR do not increase solely due to the mere extension of the time series, but significantly due to the increase in the confidence level from 99% to 99.9%.

The paper provides no rationale for such a blanket methodological change to the 99.9% confidence level. In our opinion, a reference to "higher conservatism" is not sufficient as an economic argument, **especially as**

there is no quantitatively supported justification as to why the current degree of conservatism would not be sufficient. We believe that no adjustment should be made here. According to the tables in the consultation paper, the scenarios would also be tightened in the 99% percentile for the EUR area, which already results in a higher conservatism compared to the previous parameters. Another source of existing conservatism is that the higher value of the upward and downward shocks is automatically applied as the new shock value for the recalibration of the supervisory shock scenarios, without this being justified.

As the new SOT (formerly the early warning indicator) is already significantly more conservative than the previous SOT methodology[1], **a further tightening due to the new interest rate shocks could further restrict a reasonable management of interest rate risk and force banks into transactions that are not necessary or even counterproductive from a business perspective**.

Even if exceeding the SOT thresholds does not automatically result in supervisory measures, it is nevertheless to be expected and required by the supervisory authorities that the SOTs are incorporated into the banks' management. With the confidence level of 99.9% and the derivation of ad-hoc interest rate shifts from 6-month changes, an absolute extreme situation would thus constitute the basis for the supervisory assessment of the banks' general interest rate risk situation and for the banks' own interest rate risk management.

The methodology for deriving the interest rate shock parameters already includes enough conservative components (e.g. length of the interest rate time series and long-time window for interest rate changes, which are applied ad hoc), thus the confidence level does not have to be additionally increased from 99.0% to 99.9%.

For institutions with **foreign currency positions**, a very high degree of conservatism is already achieved by recognising 100% of losses and only 50% of gains. If this were to be combined with a confidence level of 99.9% for derived interest rate shocks, **increasingly erratic results would follow**. The observations at the edge of the distribution in different currencies should not be different than at a 99% confidence level.

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[1] i.e. 15% of an institution Tier 1 capital vs. previous: 20% of its own funds in case of SOT on EVE; and selecting the least favourable from 6 instead of previously 2 shock scenarios.