

EBF Response to BCBS Consultative Document (CD) on Interest rate Risk in the Banking Book (IRRBB)

The European Banking Federation (EBF) is the voice of the European banking sector, uniting 32 national banking associations in Europe that together represent some 4,500 banks - large and small, wholesale and retail, local and international - employing about 2.5 million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that securely handle more than 300 million payment transactions per day. Launched in 1960, the EBF is committed to creating a single market for financial services in the European Union and to supporting policies that foster economic growth.

Key messages

- Support for the comprehensive and detailed joint association¹ response to the BCBS CD on IRRBB
- The scope of IRRBB should be carefully considered and determined
 - The banking book should be clearly defined
 - Credit Spread Risk in the Banking Book (CSRBB) should be separated from IRRBB
 - Applicability at sub-consolidated level proportionate to the sophistication of the entities should be considered
- The EBF recommends applying a Pillar 2 framework based on Binding Sound Practice Principles for IRRBB and Tests to identify potential outlier Banks, and considers that a Pillar 1 framework is not appropriate for IRRBB.
- Behaviour assumptions should not be standardized with one-size-fits-all fixed set of parameters as they result from each banks' specificities and, consequently, should be estimated through internal models. Hard coded behaviour models would not be appropriate neither for regulatory framework, nor for public disclosure.
- Capital need for IRRBB should be derived from a risk of loss due to IRRBB on a dynamic/going concern basis. Non-interest bearing liabilities and non-interest bearing equity should be considered specifically given the absence of loss risk.
- An ill-defined regulatory framework for IRRBB would have severe consequences impacting not only banks but the economy as a whole. The comments of the industry should be considered together with the feedback of the QIS to properly assess the impact on banks and their ability to provide key services to the retail customers.
- As the proposals in the BCBS CD will have to be altered significantly, another consultation should be organized to provide opportunity to review the amended proposals.

¹ Institute of International Finance, IIF; International Banking Federation, IBFed; Global Financial Markets Association, GFMA; International Swaps and Derivatives Association Inc., ISDA

The EBF comments on the Basel Committee Consultative Document on Interest Rate Risk in the Banking Book

The EBF welcomes the opportunity to comment on the Consultative Document (CD) published on June 2015 by the Basel Committee on Banking Supervision (BCBS) on Interest Rate Risk in the Banking Book (IRRBB).

Support for the comprehensive and detailed joint association response to the BCBS CD on IRRBB

In this letter, EBF presents the view of its members and recommends changes to the CD that EBF hopes will be helpful to BCBS in updating the regulatory framework for IRRBB.

This letter is accompanied with EBF documents² sent to the BCBS Task Force on Interest Rate (TFIR) during the informal consultation period that took place since early 2013 in the form of meetings between the industry and TFIR.

The EBF supports the joint association response and intentionally does not cover all points mentioned in the joint association's response (e.g. basis risk or currency aggregation).

Scope

- *Positive definition of the Banking Book (BB)*

While mentioned by the BCBS as one of the two reasons for updating the prudential framework for IRRBB, it is surprising that the boundary between the Trading Book (TB) and the Banking Book (BB) is not addressed by the consultation.

To address the boundary issue, the EBF proposes inclusion of BB 'eligibility principle'. This would enable to elaborate a positive definition of the BB, as opposed to considering BB as what is not eligible to the TB.

Financial instruments, such as loans, deposits, financing facilities, which can usually not be allocated to the TB and are necessarily part of the BB, would not need to be subject to specific requirements for preventing boundary arbitrage. Similarly, non-financial instruments such as equity, tangible and intangible assets, net property, premises and equipment would not be subject to such specific requirements.

Various banking laws are in place in several jurisdictions (existing national laws such as e.g. Belgium, French, and German Banking Laws or in the making such as the Regulation on structural measures to improve the resilience of European Union credit institutions) whose objective is to exclude or identify transactions that should be considered as trading positions. The EBF would suggest leveraging upon the existing legislations and regulations to derive a common positive definition of the banking book.

² http://www.ebf-fbe.eu/wp-content/uploads/2014/07/EBF_009173-EBF-Position-paper-on-the-IRRBB-Final-30June2014.pdf
http://www.ebf-fbe.eu/wp-content/uploads/2015/02/EBF_013038-EBF_012778-IRRBB-FAQ_January-2015.pdf



A positive definition of the BB would also be useful to determine the Internal Risk Transfer (IRT) transactions which would be eligible for inclusion in the BB.

We acknowledge that further discussion should be held on the eligibility criteria and we would be happy to work together with the BCBS on the banking book eligibility criteria.

- ***Credit Spread Risk in the Banking Book (CSRBB) should be considered separately***

The BCBS CD provides only a broad definition of CSRBB whose meaning remains unclear. The CD is silent on how CSRBB should be considered in BCBS CD's Pillar 1 proposal which is simply referred to in the BCBS CD's Pillar 2 proposal as a component of IRRBB.

The EBF considers that CSRBB is fundamentally different from IRRBB in nature, in risk management and in the articulation with existing regulatory framework (e.g. capital allocated for credit risk). The EBF recommends that CSRBB is considered separately from IRRBB. In all the sections below, only IRRBB, excluding CSRBB, is referred to.

- ***The level of application should be carefully considered***

The BCBS CD proposals are destined to 'large internationally active banks on a consolidated basis'. However, it is mentioned that national regulators might elect to apply this framework at different level of consolidations, including on entity basis. As an example, European authorities tend to require BCBS proposals on both group consolidated basis and on sub-consolidated basis (up to entity level).

EBF recommends that BCBS should take into account that its proposals are applied at different levels of consolidation to make sure that they are actually applicable, and that the requirements are proportionate to the sophistication of the scope it is applied to. As an illustration, requirements on behaviour models and risk metrics should be made simpler for unsophisticated entities. It should also be made clear that unsophisticated entity within a sophisticated group could contribute to the group based on their level of sophistication. This should be acknowledged by regulators prescribing consolidated metrics or templates to global institutions.

Support for a Pillar 2 framework based on Binding Sound Practice Principles for IRRBB and Tests to Identify Potential Outlier Banks

- The EBF supports Binding Sound Practice Principles similar to Principles 1 to 7 contained in the BCBS CD.
- The EBF supports Principle 8 on:
 - regular and on-request IRRBB reports to supervisors, including limit monitoring, and
 - regular public disclosure on IRRBB which would typically include both
 - qualitative description of the IRRBB management framework, including governance, behaviour model and applicable risk metrics, and
 - quantitative reports on sensitivities to both NII and EVE based on banks' internal models for a standard parallel up and down par of scenarios to be defined by BCBS

Such reports should not include any form of hard coded one-size-fits-all behaviour model-based metric for the reasons explained in the next section. The BCBS QIS qualitative questionnaire actually illustrates how ill equipped standardised reporting templates are to capture the diversity of IRRBB even within the same institution.

When responding to the qualitative questionnaire at a consolidated level the questionnaire did not enable to choose more than one option from the multiple choice form which did not reflect the variety of approaches at the level of subsidiaries. The diversity appears not only within the industry given the variety of business models and jurisdictional differences but even within internationally active /multi-business groups.

Whilst the EBF is supportive of enhanced supervisory disclosure, we question the requirement to notify the supervisory in advance of any significant changes to e.g. behavioural assumptions or methodologies. We are of the view that this naturally is covered as part of the SREP discussions under Pillar 2.

- **The EBF supports that Outlier Tests (OTs) based on both economic value sensitivity and net interest income sensitivity to a regulatory-set predefined interest rate shocks are used to help supervisors identifying potential outlier banks**

The OTs should be based on bank's own behavioural models (including the choice for the investment of equity). Also, it should be made clear, as in the Guidelines on non-Trading Interest Rate Risk published by European Banking Authority (EBA), that those OTs are used to inform of potential interest rate risk that would be identified as outlier compared to other similar banks (i.e. operating in similar jurisdictions, with similar products and similar business models) and that no automatic conclusion could be derived from any single one of the two OTs. As they measure sensitivities (i.e. variability risk), OTs could not be used to derive internal/regulatory capital.

Though it would not be fully consistent with the recognition of behavioural models which include the choice of investment of equity, but given that they do not trigger automatic capital charge, the EBF would accept, as a fall-back solution, using the sensitivity of Economic Value of Equity (EVE) instead of the economic value of the banking book (EV) in which the equity is considered for its chosen investment. Sensitivity of EVE would provide the actual implied duration of equity, which could be used by supervisors to run horizontal analyses with similar banks and identify outlier banks.

It is important that the EVE and NII OTs are considered simultaneously, each one being allocated a specific threshold to be calibrated ($[x\%]$, $\{y\%\}$) so as to test that the NII and the economic value variation is kept within acceptable boundaries that serve as a trigger for discussion with the supervisor.

Hence, OTs would offer supervisors with comparable metrics based on identical interest rate scenarios, which would support their horizontal analyses for the identification of potential outlier banks, while recognizing that behaviour model should be adapted to facts and circumstances in which banks operate.

- The EBF supports that the Internal Capital Assessment Process (ICAAP) should cover IRRBB for potential needs for capital.

The internal capital, as any potential required regulatory capital, should relate to risk of loss, and not opportunity cost. This is detailed further in the document.

Behavioural models

- *Behavioural assumptions should not be standardized with one-size-fits-all fixed set of parameters*

The EBF strongly believes that behavioural models cannot and should not be standardized with a fixed set of one-size-fits-all quantitative parameters. Any one-size-fits-all set of hard coded behaviour models would fail to convey the risks that are dependent on products, customers' behaviours, competitors, jurisdiction-specific regulatory environments (e.g. tax or consumer protection law) etc. This would lead to a misleading perception of comparability while in fact hiding actual risks or creating fake risks. Such misleading information would be highly inappropriate for both regulatory framework and public disclosure.

Non Maturing Deposits (NMDs) and pre payable assets are very important illustrations of such balance sheet items whose interest rate exposures need to factor in their idiosyncrasies. Supervisors would certainly not accept that a bank uses hard coded one-size-fits-all parameters for behavioural models for the management of IRRBB as it would ignore facts and circumstances specific to IRRBB management.

- *Sound practice principle for behavioural models, including the possibility for investment of equity, such as the suggested Principe 6 should be incorporated in the regulatory framework*

Behavioural models must be subject to robust framework, notably in terms of governance, review process and information to supervisors. This would enable to ensure that they are continuously adapted to facts and circumstances, and used for both actual risk management and regulatory needs.

The EBF suggests that sensitivities to changes in the behaviour assumptions, including breakdown of behaviour assumptions, should be regularly calculated and reported so that the management of the organization is aware of those sensitivities.

Capital need for IRRBB should be derived from a risk of loss due to IRRBB and relate solely to IRRBB

The EBF strongly believes that capital for IRRBB is needed only to the extent that there is a risk of loss due to IRRBB, that is to say a risk that the capital of the bank will be reduced through negative earnings resulting from the effect of an adverse interest rate scenario. One approach for the calculation of loss risk that the EBF considers appropriate would be to calculate future earnings on a dynamic / going-concern basis consistent with each envisaged interest rate scenario. Hence, prepayments and potential changes in balance sheet mix attributable to interest rate changes would be taken into account for each interest rate scenario.

Capital for IRRBB should relate to IRRBB only. Changes or events that would not be driven by interest rates, such as credit risk event, reduction of equity etc. that could have indirect effect on IRRBB should be considered separately in regular comprehensive stress test exercises which combine different sources of risks, and not co-mingled with the identification of potential capital needs due to IRRBB. These cross-risks comprehensive exercises are used by supervisors to identify whether additional capital is needed also in a gone concern scenario. This is done through the Comprehensive Capital Analysis and Review (CCAR) process in the United States, and through the European Central Bank Stress Test in Europe through the Single Supervisory Mechanism.

Hence, it is unnecessary and it would be inconsistent to include non-interest rate-driven events in the identification and measurement of potential capital need due to IRRBB.

Measurement of loss risk

An appropriate approach to measure loss risk would be to envisage different interest rate scenarios in order to identify loss risk on dynamic / going concern earnings, over a several year horizon (H), with changes in level, slope and shape of the interest rate curves. Banks would forecast their future earnings over the considered horizon (H) in each interest rate scenario and identify the scenarios that could lead to earnings loss. This approach would be based on banks' behavioural models and based on robust and reviewed implementation of Principles 6 and 11.

The changes in interest rate curves should be consistent with the horizon (h) over which the IRRBB is mitigated by the institution which would typically be three months horizon. The regulatory-defined interest rate scenarios for OTs could be considered in the ICAAP for IRRBB process.

Treatment of non-interest bearing liabilities and non-interest bearing equity given the absence of loss risk

There is an opportunity cost / variability risk from the investment of non-interest bearing funding sources, but there is no loss risk.

Non-interest bearing funding sources provide valuable buffer against adverse interest rate scenarios. Non-interest bearing liabilities and equity provide banks a stream of positive earnings with non-interest bearing funding sources invested in interest bearing assets. As a consequence of the stream of positive earnings, non-interest bearing funding sources provide positive economic value for the bank (corresponding to the discounted value of the expected positive earnings): no loss risk derives from non-interest bearing funding sources. This positive stream of earnings and the positive economic value act as natural buffers against adverse interest rate scenarios that could lead to lower earnings and/or lower economic value, and hence mitigating against loss risk. The mitigation is all the more important as non-interest bearing funding sources are high and stable, as supported by historical data analyses, and as the level of interest rates is high (since the earnings from investing the non-interest bearing funding sources in interest bearing assets increase with the level of rates).

This stream of positive income is sensitive to change in interest rates. Indeed, the assets in which they are invested necessarily reprice over time either because they are floating rate



assets, or because they mature and need to be replaced by other assets to reinvest non-interest bearing funding sources. Even though the positive stream of income can be made less sensitive to changes in rates with assets with longer fixed periods, it is impossible to fully cancel out the sensitivity to rates. Hence, there is no variability risk-free strategy for the no loss risk investment of non-interest bearing funding sources.

In their investment strategy for non-interest bearing funding sources, banks choose investment profile consistent with the expected stability of those funding sources and their business model. This investment profile is and should be reviewed by the most senior management level of the organization.

This is a very different situation than for interest bearing balance sheet items with contractual characteristics (i.e. no behaviour-dependent characteristics) since each of these items can be perfectly hedged with one single variability-risk-free strategy. There is a loss risk to the extent that the single variability-risk-free strategy is not implemented. An investment in a fixed rate bond, such as German Bund, is an example of such interest bearing asset with only contractual characteristics, which can be perfectly hedged against change in interest rate by entering into a fixed rate payer / OIS receiver swap.

Consequences of an ill-defined regulatory framework for IRRBB

An ill-defined regulatory framework for IRRBB will have consequences, most of them probably unintended by BCBS, as banks will have to adapt to it.

Indeed, banks will be strongly incentivized to manage IRRBB along the regulatory framework perception of risks. To the extent that the regulatory framework departs from actual risk perceived and managed by banks, banks will be facing a dilemma: i) alignment to regulatory framework (notably to avoid the penalizing capital charge) or ii) managing actual risks (and suffering from the ill-defined capital charge).

Moreover it could have material impacts on the economy such as decrease in maturity transformation activity, pass-on of interest rate risks to customers, restriction on availability of credit, higher costs for customers. The impacts of the IRRBB framework on banks' abilities to provide their services to the wider public need to be considered.

i) Alignment of risk management to the regulatory framework

The combination of standardization of behavioural assumptions, with far too short durations for non-maturing deposits (NMDs) and with an EVE-biased regulatory framework, would lead banks to adopt similar short term profile for the investment of equity and non-maturing deposits. Banks would hence be similarly exposed to changes in rates. This framework could create significant systemic risk. The return on equity would be made more volatile, which is detrimental to the ability to tap the market for new capital, if needed, and it will increase the cost of equity for banks since investors will expect a higher premium for accepting more volatile return.

Banks would also be incentivized to stop offering long term fixed rate loans, including mortgages to their customers. This will subject banks' customers to endorse more interest rate risks, potentially creating another source of systemic risk as customers would be directly exposed to fluctuations in interest rates.

ii) Sound management of banks' risks

Should banks decide to continue with the risk management practices, they will be charged capital for managing soundly actual risks rather than managing regulatory-perceived risks. This would simply amount to a 'penalty for sound management of IRRBB', which hardly makes sense.

Capital charge will likely be factored in a higher margin between assets and liabilities, with lower interest rates on liabilities paid to customers and/or higher interest rate charged to customers' assets.

Need for additional consultation

The EBF considers that the CD proposals are not appropriate since they are based on highly standardized framework with capital need based on variability risk rather than loss risk, and as such they would misinform both supervisors and financial statements' users. The EBF recommends that the suggested Pillar 2 framework is leveraged upon but cleaned of what the EBF considers to be fatal flaws as explained in this letter.

The EBF would appreciate that the comments of the industry are taken into the account when reviewing the IRRBB framework together with the feedback of the QIS in order to properly assess the impact on banks and their ability to provide key services to the retail customers.

As the proposals in the BCBS CD will have to be altered significantly, the EBF recommends that another consultation is organized to provide opportunity to review the amended proposals.
