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**FBF response to Basel Committee on Banking Supervision Consultative Document:
“Recalibration of shocks for interest rate risk in the banking book”**

Introduction

The French Banking Federation (FBF) welcomes the opportunity to express the views of the French banking industry on the BCBS Consultative Document on the recalibration of shocks for interest rate risk in the banking book. In this context, we herewith provide you with our response.

We appreciate your consideration about our answer and remain at your disposal for further clarifications.

In summary, the Consultative Document (CD) proposes four main evolutions from the 2016 methodology:

- the extension of the time series used to calibrate the interest rate shocks that we support,
- the use of an absolute interest rate shock instead of a relative shock, considering the change of interest rate regime during the dataset horizon, that we agree with,
- the use of currency-specific shock instead of global shock applied to all currencies that we also support and
- the use of a 99.9% percentile instead of 99% to determine the shock severity that we reject since it appears that the recent interest rate increase is not an outlier compared to the previous calibration period and that the switch from a relative to an absolute shock is not less conservative.

As a technical synthesis of the French banking industry views, you will find in appendix a paper from the Association Française de Gestion Actif Passif (AFGAP), a French Asset and Liability Management (ALM) experts' association, which analyses historical data for EUR and USD which are the main currencies for French banks.

Points of attention

As a preliminary remark, we wish to draw the Committee's attention to 2 points to be taken into account when the IRRBB framework is modified:

- First, it is essential to consider that the proposed recalibration will affect the jurisdictions that have fully implemented the BCBS Standard with its binding SOT, such as Europe. Indeed, supervisory shocks are used for the calculation of Supervisory Outlier Test (SOT) that are accompanied with fixed thresholds of 15% of Tier One Capital for SOT on Economic Value of Equity (EVE), and 5% of Tier One Capital for SOT on Net Interest Income (NII). This change in the calibration will be all the more impactful as banks should factor them in their IRRBB management framework which usually leads to adopt even stricter internal thresholds either self-imposed by banks or under the supervisory pressure. But we can see that the CD is fully silent on the impacts that a change in percentile might have on banks' business models and management of interest rate risk in the banking book.

We consider that since the thresholds applicable to *SOTs* are locked in binding regulation, there should not be methodological change on the calculation of *SOTs*, notably on the supervisory interest rate shocks to apply. Increasing the supervisory shocks will mechanically increase the number of banks identified as outlier hence deviating from the threshold calibration method. To avoid being an outlier, banks will have to adjust strategies, risk appetite, internal limits, banks profitability and ultimately deploying effects on features and prices of banks' products. As this could lead to unintended consequences for the banking industry and even the way banking products being offered, this needs to be carefully considered. Hence, careful considerations should be paid to the ramifications of any change to the percentile of supervisory shocks in a context where the applicable thresholds are fixed. As an illustration, the envisaged increase of +25% in the magnitude of supervisory shocks in EUR (± 250 basis points, bps, vs. ± 200 bps) – all other things being equal, i.e. in the absence of *SOT* thresholds recalibration - would basically make the European *SOTs* 25% more binding (it would be equivalent to reducing the threshold to 12% and 4% respectively for the *SOT EVE* and *SOT NII*). Such a change should not be considered as a 'technical' change to supervisory shocks.

It is worth reminding that not all jurisdictions have implemented the BCBS *SOT*. The changes in supervisory shocks would magnify the uneven playing field and penalize banks from jurisdictions having an adequate regulatory framework fully compliant with BCBS principles (including *SOT* with threshold) such as the European one. More generally, this will contribute to a more severe regulatory environment in Europe which will have a negative impact on the European banking system, and particularly on French Banks.

- Second, it is important to stress that the rate volatility has actually *not* increased since the previous calibration period that was between 2000 and 2015 and included interest rate volatility during the Global Financial Crisis (GFC) of 2008-09 that was exceptionally high. Indeed, there may be a perception that the recent past has evidenced an increase in rate volatility as we observed the speed of rate hikes in many jurisdictions. That does not necessarily mean the volatility in interest rates is higher than in the past. Indeed, the peak of the EUR interest rate shock in 2022-2023 is lower than that experienced in 2008-2009.

Proposed methodological changes

Extension of the observation period

Basing the supervisory shocks on an observation period from 10-20 years ago while ignoring the most recent period would not be appropriate. The extension of the observation period to include the years 2016-2022 is therefore deemed appropriate. Going forward, the BCBS should consider incorporating a rolling observation window between 15 and 25 years of historical data long enough to cover different cycles and not too long to remain relevant.

Absolute Shocks vs. Relative Shocks (see part 2 of the AFGAP study in appendix)

We support the Committee's proposal to switch from relative to absolute shock approach as it makes sense to adopt an *absolute* shock methodology in a normalized interest rates environment after a long period in a low interest rate environment. However, there is no economic substance in presenting the adoption of absolute shock as an accommodation as non-sensical relative shocks would be excessively high compared to economically sound absolute shocks. As a consequence, the proposal to substitute a 99.9% confidence interval to the 99% confidence interval to offset the accommodative change is simply not founded.

Use of currency-specific shock instead of global shock applied to all currencies

Interest rates differ in terms of volatility and empirical shock sizes between currencies and observable shocks are not necessarily driven by the level of interest rates. The previous methodology of applying a scaled global shock has therefore led to the over-estimation for currencies with relatively low volatility while it has led to under-estimation of representative shock sizes for currencies exhibiting high volatility. To adequately capture currency specific volatilities, it is therefore deemed appropriate to switch to currency specific shocks.

As a consequence, currencies with a relatively low degree of volatility or simply a relatively high level of interest rates should see their shocks reduced to become more representative while currencies with high volatility or simply a very low level of interest rates should see their shock sizes increase as visible in table 8 of the BCBS consultation paper.

Methodology Change from 99% to 99.9% Confidence Interval (see part 3 of the AFGAP study in appendix)

We do not agree with the Committee's reasoning that the change was needed to "*maintain sufficient conservatism in the proposed recalibration.*" The CD does not provide any empirical or even theoretical foundation to substantiate this assertion. The proposed methodology, utilizing the same 99% confidence level, would not be less conservative than the current one. We note that the CD states that keeping the confidence level at the current 99% level would result in a decrease in shock factors for many jurisdictions and would therefore lack conservatism. However, Table 8 in the CD shows the new methodology, utilizing the 99% level, would be as severe on a relative basis as the current methodology — 14 increases (22%), 15 decreases (24%), 34 unchanged (54%). The analysis conducted by AFGAP shows that "*applying the absolute shock methodology with a 99% probability to the previous data set (i.e., from 2000 till 2015) would have led to the same or higher shock levels (except for short shock for USD) than in the BCBS 2016 methodology for EUR and USD*" and similar conclusion is true for data set till 2022.

Besides, the change from 99% to 99.9% confidence interval has several fatal flaws:

- Indeed, in addition to being a fundamental deviation from the calibration that was used to set in stone the *SOT* thresholds, the change makes the methodology extremely sensitive to only a very few points, i.e., 5 historical data points and it is exacerbated by the rolling window approach in computing absolute changes. This makes the proposal mathematically flawed and too conservative. The rolling window approach introduces a structural bias as each "data point" is not independent from the previous one and it implicitly weights several times the periods characterized by high volatility that fall in the tail of the distribution. With a sample of 22 years (5,375 data point) a 99.9% is equivalent to take the value of the worst 5th data point. This high confidence level, 99.9%, combined with the rounding might also generates odd cases where the shocked proposed by BCBS is higher than the worst data point observed in the sample.

When considering EUR, the 5 points that lead to a +25% increase in EUR supervisory shocks date back to the *2008 Great Financial Crisis* (GFC) for *downward* interest rates which has nothing to do with the recent increase in rates. That is why we urge BCBS to keep the 99% confidence interval in any case.

- the 6-month horizon of the shocks represent also an element of conservatism embedded in the framework. As the shock relates to a six-month horizon, it appears inconsistent and extremely conservative to assume that it applies immediately. We recommend clarifying that the shock is applied after six months. Without such a clarification, the methodology would not be technically well founded. Should immediate shocks be elected by the regulator, the shocks that relate to a 6-month horizon should be scaled down to remain consistent.

Appendix – AFGAP technical study

Please find below the AFGAP technical study.



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