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Comments on the BCBS Consultation Document (CD) on Interest Rate Risk in the Banking Book (IRRBB) published on June 8th, 2015

Febelfin vzw/asbl (non-profit association) is the **Belgian Financial Sector Federation** and defends the interests of large banks, small and medium-sized banks, niche players, providers of infrastructure, etc. It speaks on behalf of the Belgian financial sector as a whole (except for the insurance companies).

Febelfin welcomes the opportunity to comment on the above mentioned BCBS CD on IRRBB. This letter, representing the joint response of Febelfin's members, should be read together with the following response documents which will be equally sent to the BCBS:

- the joint IIF/IBFed/GFMA/ISDA response,
- the response of the European Banking Federation.

Febelfin highly supports the viewpoints which are expressed in these answers.

EXECUTIVE SUMMARY

The Belgian Financial Sector Federation wants to highlight the following key messages, which are mainly of a conceptual nature, but substantial for the future of the local business.

- Febelfin strongly opposes to the proposed simplified and standardised Pillar 1 approach, as we consider it being inconsistent, ineffective and having too much unintended consequences; the same holds for the proposed standardisation in the Pillar 2 option.
- Febelfin continues to support a true Pillar 2 approach, based on a transparent cooperation with the regulators and binding and sound practice-principles for IRRBB which allow to reflect economic evidence. In line with this approach any possible capital reservation for IRRBB should thus be based on loss risk and not on variability risk. The outlier test which already applies in Belgium should be further developed and fine-tuned.
- Specific behaviour linked to the Belgian local market products cannot/should not be standardised with worldwide one-size-fits-all parameters. The impact of the proposal “as such” on the sector would be detrimental, both to the business model as to the profitability/capital accretion of most of our sector members.



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1. An inconsistent and ineffective standardised proposal

a. Proposed Pillar 1 (P1) and standardised Pillar 2 (P2) approach

- **The proposed highly simplified and standardised Pillar 1 approach would lead - in a rather mechanical way - to a Minimum Capital Requirement for IRRBB.**
- The required calculation of a Pillar 1 - alike standardised framework, embedded in the **proposed alternative “enhanced” Pillar 2 approach**, is seen by Febelfin as a strong benchmark from which it will most probably be very difficult for the supervisors to agree on any significant departure. Additionally, the supervisors are urged to constrain any internal modelling for Pillar 2. As a consequence, Febelfin considers the proposed Pillar 2 option as a “Pillar 1 in disguise”.
- As both of the standardised approaches would result in almost the same outcome for Febelfin’s members, we will comment equally on them as being **“the standardised P1 /P2”**.



b. Inconsistencies in the standardised P1/P2

- Febelfin strongly opposes to the proposed standardised P1/P2 approaches as the proposed combination of value and earnings based required capital is not consistent with the measurement of the available capital.
- **Value Approach:** value losses/gains on banking book positions are reflected in available regulatory capital only to a minor extent (i.e. through AFS bonds). An economic value based capital requirement is therefore subject to a fundamental **inconsistency**: capital is to be set aside for risks that do not have immediate impact on available regulatory capital when these risks emerge. Value losses in IRRBB mostly represent opportunity losses, whereas available capital is only impacted by real (or accounting) losses.

This inconsistency is a typical IRRBB issue as it does not appear in other domains: e.g. credit or trading losses do have a more direct impact on available (accounting-based regulatory) capital.

In the CD, the BCBS touches upon the above criticism (e.g. p. 31), but decides to avoid the complexity to redefine a value based capital base for IRRBB anyhow.

Febelfin admits that a consistent value based approach would indeed induce additional complexity and potential non-transparency. **However, we deem that this is rather an argument not to include a value based IRRBB approach in the standardised calculation.**

- **Earnings approach:** in some of the proposed options, capital requirements could also be based on income sensitivities linked to alternative interest rate scenarios (e.g. if simulated (multi-year) NII in case of a parallel shift of the curve leads to a lower NII than in the case of constant rates, capital is to be set aside to cover this “loss”). Such a methodology ignores that even in the adverse case of a shifted curve, institutions will still be able to generate positive income - notwithstanding the lower NII base - which will contribute to regulatory capital over a multi-year horizon instead of eating it up.

Through one of the proposed options for setting capital requirements, the BCBS tackles the issue by **including an additional capital buffer linked to historical earnings, i.e. a fixed percentage of net interest income may be added to the available regulatory capital.**

Even though the approach partially mitigates the raised concern, it is unclear what the mitigating effect will be as (1) parameters will be subject to further discussion and (2) it is not clear whether the multi-year aspect will be clearly reflected in parameter setting.

- **Due to the inconsistencies between the definition of available/regulatory and required capital, the proposal is not fit for a P1 nor for a standardised P2 calculation; there is no direct link from variability risk (as to be measured in the proposals) to real losses which impact on the available capital base.**



c. Ineffectiveness of the standardised P1/P2

- **Febelfin remains convinced that much more standardisation and simplification for the sake of “worldwide” comparability will not lead to a better assessment of IRRBB by regulators and external stakeholders.**
- Applying the proposed standards on “common” Belgian products like Non Maturing Deposits (NMDs) – as is demonstrated further - would give a completely wrong picture of the real interest rate risk sensitivity of most of the Belgian retail banks.
Febelfin is deeply worried that this could lead to misinformed and wrongly-placed considerations about its members’ IRRBB management and related regulation. Febelfin supposes that the same kind of reasoning can be made for any other local context.
- **Furthermore, Febelfin fully endorses the International and European banking associations’ view that the cited motivation for the standardised approaches is not justified and certainly not in the Belgian context:**
 - Indeed, due to the implemented new Belgian Banking Law of 25 April 2014, a clear boundary is henceforth defined between the Banking and Trading Books and any trading intent is prohibited in the Banking Book. As a consequence, requiring an additional prudential charge to prevent for capital arbitrage is thus totally unjustified in our case.
 - Secondly, the worries of the BCBS about the possible “losses” in EVE due to higher interest rates should not lead to additional capital charges either (see ‘inconsistencies’ above) – in fact higher rates should be beneficial to the sector’s NII in a dynamic hedging context. Is there any consideration made about a future change in methodology once rates are at a (much) high(er) convergence level?
- **Finally, Febelfin is also worried that the continued emphasis of the BCBS on setting capital aside for the Banking Book based on value sensitivity will lead to the following other highly ineffective consequences:**
 - Higher prudential charges will be required for high margin and thus less (real interest rate) risk sensitive businesses with only a minor part of their unrealised profits at risk, which applies to most Belgian banks.
 - Failure to enforce capital to banks which have unrealised losses embedded in their balance sheet.



d. Unintended (and unwanted) consequences of the standardised P1/P2

- The BCBS acknowledges the risk of unintended consequences, if an IRRBB framework (based on value sensitivity) were to create incentives to mitigate possible declines in EVE. **In the proposals it is recognised that there is a trade-off to be made between optimal duration of equity and earnings stability.**
- However three out of four of the alternative measures that the Committee proposes to allocate capital for IRRBB are not pointing in this direction with the exception of option 4 (page 36) (please see also our comments on this option in 1.b. 3rd bullet point above), as they continue to be based essentially on the value measure.
- **Febelfin welcomes the idea in the fourth option of partially offsetting the capital requirements by a fraction of the Banking Book profits which are – due to the local context – mainly constituted of locked-in margins.**

The question remains however for how much the overlay or the fraction will impact on the final Capital Requirements as the BCBS will probably opt for a very conservative implementation.

In the new Belgian Banking Law this trade-off has to be treated at the level of the Board of each institution which has to define its risk appetite and the related risk-limits both in terms of value and interest earnings sensitivity. De facto this trade-off comes down to a certain level of accepted risk in both terms and within well-defined borders.

- **Leaving the options 1-3 for the standardised capital measures as such, in which the value sensitivity measure is clearly the dominating factor, banks would be “forced” to reduce the investment horizon of their assets substantially, so as to reduce the mechanically calculated capital charges.**

This would have as unintended consequences:

- higher prudential charges for well capitalised banks, as longer term reinvestment of this equity base would be penalising;
- higher variability of future Interest Earnings (which remain by far the sector's most important source of income as illustrated in table 6, page 58 of the National Bank of Belgium's Financial Stability Report of June 2015, see next page).



TABLE 6 MAIN COMPONENTS OF THE INCOME STATEMENT
(consolidated data)

	in € billion								in % of ¹ operating income (2014)
	2007	2008	2009	2010	2011	2012	2013	2014	
Net interest income	13.30	14.48	14.89	13.77	13.99	13.57	13.29	14.53	70.2
Non-interest income	12.57	4.18	3.29	5.57	4.75	4.49	7.05	6.16	29.8
Net fee and commission income (including commissions paid to bank agents) ...	6.90	6.14	5.02	4.34	4.38	4.48	4.97	5.34	25.8
(Un)realised gains or losses on financial instruments ⁽²⁾	3.76	-3.83	-2.74	-0.04	-0.80	0.04	0.79	-0.06	
Other non-interest income	1.91	1.86	1.01	1.28	1.17	-0.03	1.28	0.88	
Total operating income (bank product)	25.89	18.66	18.18	19.34	18.73	18.05	20.34	20.68	100.0
Total operating expenses (-)	15.59	15.97	13.98	12.48	12.32	13.01	12.36	12.66	61,2 ⁽³⁾
Staff expenses (excluding commissions paid to bank agents) ...	8.63	8.58	7.30	6.59	6.57	6.86	6.53	6.52	
General and administrative expenses (including depreciation)	6.93	7.39	6.67	5.90	5.75	6.15	5.83	6.14	
Total impairment and provisions (-)	3.18	13.31	7.36	1.83	5.02	2.61	2.95	1.35	
Impairments on loans and receivables	0.38	2.84	5.59	1.76	3.05	1.98	2.31	1.30	
Impairments on other financial assets	2.50	7.46	0.29	-0.09	1.37	-0.84	0.00	0.00	
Other impairments and provisions	0.30	3.01	2.06	0.16	0.60	1.46	0.64	0.05	
Other components of net operating income ⁽³⁾	0.66	-0.81	0.11	0.45	-0.37	0.25	0.32	0.22	
Net operating income	7.71	-11.43	-3.04	5.48	1.02	2.68	5.35	6.89	
Total profit or loss on discontinued operations	0.00	-9.04	0.00	0.97	-0.31	0.00	0.00	0.00	
<i>p.m. Net profit or loss (bottom-line result)</i>	<i>6.66</i>	<i>-21.21</i>	<i>-1.22</i>	<i>5.56</i>	<i>0.36</i>	<i>1.59</i>	<i>3.28</i>	<i>4.52</i>	

Source: NBB.

(1) This item includes the net realized gains (losses) on financial assets and liabilities not measured at fair value through profit or loss, the net gains (losses) on financial assets and liabilities held for trading and designated at fair value through profit or loss, and the net gains (losses) from hedge accounting.

(2) This figure is the cost-to-income ratio of the Belgian banking sector.

(3) Other components of net operating income comprise the share in profit or loss of associates and joint ventures accounted through the equity method, and the profit or loss from non-current assets, disposal groups classified as held for sale, not qualifying as discontinued operations and the negative goodwill recognised immediately in profit or loss.

- **Also some unintended second-round effects of a P1 capital charge for IRRBB, dominated by a conservative value metric, can be cited, which specifically relate to:**
 - **Difficulties in matching diverse customer needs**
 - Customers (retail and corporations) in need of fixed rate long term financing will have to pay higher prices as banks will have a shortening of the duration of their funding. The hedging cost for handing out long term assets (i.e. mortgage loans) will increase. This might cause certain investment projects to be postponed or even be cancelled due to no longer being profitable.
 - Customers seeking funding for their projects will find short dated or repricing loans at a cheaper price. This could bring the interest rate risk at the customers' level.
 - For the customers with saving account balances the remuneration will decrease and be less stable, as from a bank perspective the attractiveness of saving accounts from an IRRBB point is diminishing. Thereby increasing the opportunity cost for those retail customers.



- In general, the management of interest rate risk could be transferred from the regulated banking sector to the individual retail and corporate level where there is a lack of adequate instruments to manage these risks.
- **Trade-offs in existing business**
 - Banks will have to adjust their current hedged positions or increase their capital in order to absorb the new regulation.
 - This implies additional costs and will hurt the banks' profitability.
 - To compensate for this, banks might do a round of cost cutting, raising charges for customers, ...
 - If margins would erode because of the new framework some low-risk activities could be reduced.
- **Impact on the financial system**
 - A sudden increase for hedging derivatives to hedge the open IRRBB will lead to increased collateral calls in a low interest rate environment.
 - This could induce more liquidity outflows, which could endanger the stability of the financial system and could have a negative impact on customer confidence.
 - Also this could lead to an upward pressure on LT risk-free rates, directly impacting the funding cost for the real economy.
 - Finally, a too risk adverse regulatory framework could become self-fulfilling: a too short duration of assets would cause more margin volatility and loss risks easier to materialise.

High-level Febelfin conclusions on the standardised P1/P2 proposals

- Taking into account the above described inconsistencies, the “ineffectiveness” considerations and the unintended consequences in/of the standardised P1/P2 proposals, Febelfin comes to the conclusion that these proposals are simply not appropriate for IRRBB.
- Rather than further developments/proposals to resolve these fundamental issues, Febelfin insists that the BCBS would review the principles of the proposals in order to bring capital assessments in line with the industry practice – see further.
- Overall, the Basel CD aims to come to a higher level of standardisation in IRRBB – calculations. Even though added value of severe standardisation can be questioned, Febelfin deems that any standardised measure should be based on less conservative parameters (especially with respect to non-maturity deposits, see further). In addition, a.o. due to the referred inconsistencies, a standardised IRRBB measure should not be used for setting absolute capital requirements. At most, it can be used for comparing the IRRBB profile of similar institutions as part of an overall P2 assessment.



2. Proposed approach by Febelfin

a. A true Pillar 2 approach

- Febelfin continues, as it has always done in the past, to support the application of a **true P2 approach** for IRRBB.
- In this P2-context Febelfin **fully agrees to the application of the sound practice principles #1 to #7 contained in the BCBS CD**. The Belgian sector is highly in favour of having implemented in each of its member institutions a sound risk management framework, robust controls and governance in relation to IRRBB which are aligned with their specific size, complexity and general risk profile.
- Febelfin also **endorses the regulatory reporting and disclosure statements** included in **principle #8 but only in the context of a true P2 framework**, i.e. without including any hard-coded one-size-fits-all behaviour model-based metric – the sector cannot accept that any risk metric is published to external stakeholders which could potentially lead to wrong interpretations of the internal assessment and/or management of IRRBB.
- Belgian banks should be given the incentives to further develop and maintain their internal measurement systems for IRRBB in Pillar 2, especially in relation to local-specific products and markets. However the Belgian sector agrees that these systems should be subject to internal approval (by the risk department) and external notification (to the local regulator?) and thus well-documented (for transparency reasons).
- Febelfin finally observes that **Credit Spread Risk in the Banking Book is to be articulated with the credit risk regulatory framework** (and not mixed up with IRR as in the BCBS CD).

b. Outlier Test

- A regular outlier test considering both economic value and net interest sensitivities of the BB already exists in the Belgian regulatory context since almost a decade. **The NBB has brought this test in line with the “EBA-guidelines on non-trading IRR”. Febelfin regrets however that some standardisation with regard to NMDs (please see further), which had been originally defined in a completely different market environment, has not been taken out of this framework in the context of this update.**

Consequently, the resulting metrics are quite different from internal observations and should not to be used for interpretation by any other external stakeholder apart from the regulator himself.



- **Febelfin remains strongly in favour of the further application of this Outlier Test by the regulators, but also wishes to stress once again that**
 - The resulting value and earnings metrics are to be **equally considered** in the testing. A too one-sided approach could be detrimental to business models and - by extension - the economy.
 - These tests should not be used to derive internal / regulatory capital but only serve as an indicator.

c. Capital for IRRBB

- Febelfin fully supports the view that **(regulatory) capital needs for IRRBB should derive from risk of loss (i.e. reduction of regulatory capital) due to IRRBB** (i.e. resulting from an adverse evolution of the interest rate curve).
- Febelfin is of the opinion **that the Internal Capital Assessment Process (ICAAP), which is common industry practice, should also cover IRRBB** for the potential needs for capital. To this end, there should be made within each bank on a regular basis:
 - an integrated multi-year (3 to 5 year) stress testing **as part of P2** calculations, where impact of lower than expected NII on available capital is integrated with impact arising from other risk types;
 - if **a value based approach** is set as part of P2, it should be seen **in conjunction with the earnings based approach**, i.e. to assess the remaining IRRBB risks beyond the multi-year stress testing horizon. This can be in line with the current supervisory shock methodology as described in the EBA guidelines for interest rate risk management.

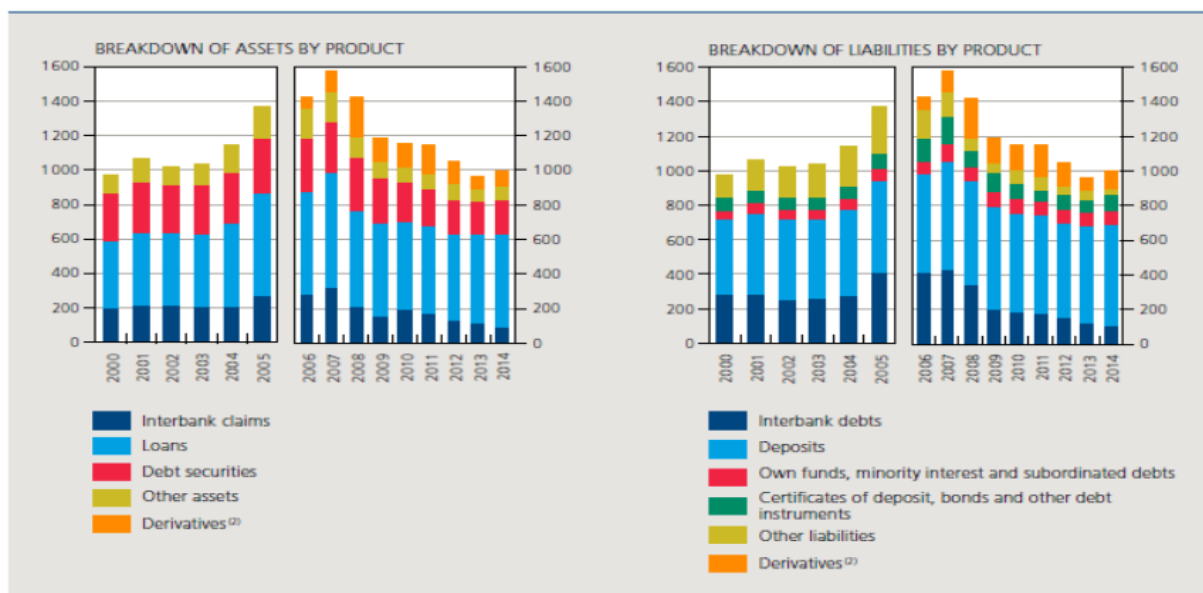


3. Proposed standardisation for local-specific products and impact on the local Retail business model

a. Balance Sheet structure of the Belgian sector

- The evolution of the Balance Sheet structure of the Belgian Banking sector is illustrated by chart 9 (page 47) of the NBB Financial Stability Report of June 2015:

CHART 9 BALANCE SHEET STRUCTURE OF BELGIAN CREDIT INSTITUTIONS ⁽¹⁾
(consolidated end-of-period data, in € billion)



Source: NBB.

(1) Data compiled in accordance with the Belgian accounting rules until 2005 (Belgian GAAP) and IAS / IFRS from 2006.

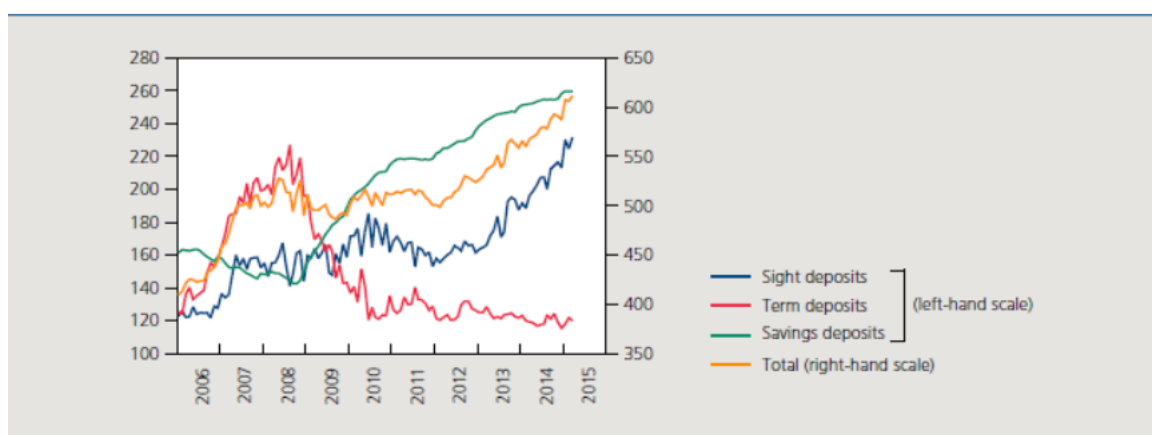
(2) Derivatives are recorded at their market value including, from 2007, income receivable and expenses payable.

- Commercial deposits constitute the bulk of the liabilities side; they can be considered as the natural funding of the commercial loans on the asset side.



- Taking into account the local economical context, we can observe the following specificities:
 - **NMDs, both savings and current accounts, constitute by far the largest part of the commercial deposits** (see also next graph, chart 19 (page 63) of the NBB Financial Stability Report of June 2015)

CHART 19 CUSTOMER DEPOSITS
(unconsolidated data, in € billion)



Source: NBB.

- **Fixed rate mortgages and investment loans are dominating the commercial loan portfolios**

b. Proposed standardised treatment of NMDs

- **The proposed standardisation of NMDs, by which Febelfin is particularly concerned, would lead to a de facto maturity shortening of these liabilities to max 1.5 years for savings and non-transactional current accounts and 1.8 years for transactional current accounts, which is to be compared to the current regulatory treatment in Belgium of 2 years for savings and 5 years for current accounts (as a whole) and local market benchmarks based on internal models of respectively 2.5 years and 5 years.**
- **In line with the industry worldwide, Febelfin considers the proposed standardised treatment of NMDs as far too restrictive and in sharp contrast with both the recently published EBA guidelines and the banks' risk management practices.**



- The proposals should not mix liquidity risk with interest rate risk considerations to end up with an ultra-conservative parametrisation. Febelfin fully supports the view that the representation of NMDs in the IRRBB framework should focus on an adequate modelling of the interest rate sensitivity and not refer to the aspects of funding or liquidity.
- Applied to the Belgian context the application of one-size-fits-all parameters like pass through floors, stability caps and maturity caps has little economic sense as illustrated hereafter.
 - The very largest part of the Belgian savings have to be classified as retail non-transactional, and according to the proposed rules more than 50% of these would have to be considered as being non-core and placed overnight. However, the very local nature of these deposits, including a fidelity remuneration premium, ensures that the “core” part as modelled by the sector’s members is considerably higher....
 - The main part of the sight deposits, both retail and wholesale, is not remunerated; so imposing a pass-through floor on them is simply not correct. Rate differentiation based upon “transaction ability” is not appropriate within the scope of an interest rate policy. Liquidity considerations are tackled within liquidity risk management by the holding of a liquidity buffer.
- Representation of NMDs in the earnings measure: the core NMDs are defined in such a way that they represent a stable funding source. However, **in the EaR calculation, the level of stable funding decreases in a drastic way. It would be more logical to keep the level of core NMDs constant in a dynamic renewal**
- Furthermore, we understand the need for a non-stable part of NMDs from a liquidity point of view. But **we are of the opinion that a combined scenario of massive deposit outflows and yield curve changes misrepresents the earnings at risk linked to the IRR.** It would make sense to let also the non-stable part mature over a longer period.

c. Possible impact on the Belgian Retail Bank business model

- The very simplified and conservative approach to define the duration of the NMDs, leading to important capital requirements in this standardised approach, could have significant impact on the Belgian banking landscape and product offering. In combination with the Equity that would be considered as an overnight liability, basically the whole liabilities side of the sector would be considerably shortened versus most banks’ internal modelling practices.
- There is a high probability that this would incentivise the risk management to shorten the assets side accordingly, mainly in customer loans. This would de facto transfer the IRR from the banks to the clients (with negative consequences in a rising interest rate environment)



- Furthermore, the shortening on the assets side would also make the recurring net interest income base much more volatile which is not what a sound and prudent IRRBB management is about.

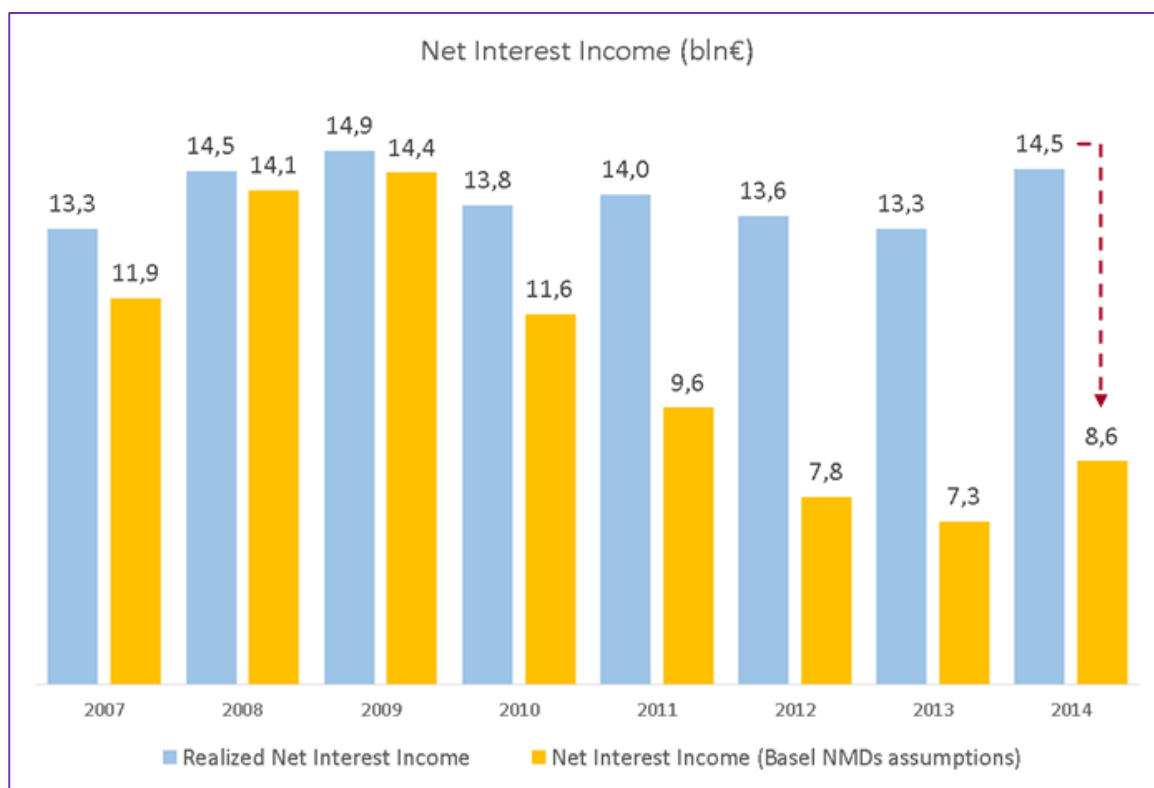
d. Quantitative estimation of the possible impact of the Basel proposals on the Belgian banking industry

- Based on table 6 of the NBB Financial Stability Report of June 2015 to which we referred earlier (see page 6), the Belgian banking sector has made a first gross estimation of the possible impact of the Basel proposals on the Belgian banking sector as a whole.
- **Up to EUR - 6 billion carry loss in 2014**

Over the period **2007-2014** the **Belgian financial sector proved its ability to maintain a stable interest margin around EUR 13 -15 bln** despite of fluctuating market rates.

Taking into account the Basel NMDs' assumptions, the **interest margin¹** would have been **extremely volatile** ranging between EUR 7.3 bln and EUR 14.4 bln (variation > 50%).

Assuming Basel NMDs' assumptions, the interest margin¹ would thus have been EUR **~6bln** lower in 2014.



(1) Ceteris paribus (i.e. pricing customers deposits, loans,...)



- **whereas “business as usual measures” could only marginally address the issue**
(= carry loss of EUR -6bln) ...



- The gross estimations of the possible impact clearly illustrate that it could consequently become **very difficult for the Belgian banking sector as a whole to maintain its stable interest margin under the proposed Basel NMDs’ assumptions**; as a result this could also seriously weigh on the profitability of Belgian banks and even be a possible threat for the financial stability.

We sincerely hope that these comments and suggestions can assist you.

Yours faithfully,

Rik Vandenberghe
Chairman

Michel Vermaerke
Chief Executive Officer