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French Banking Federation response to
BCBS d319 Consultative Document relative to interest rate risk
in the banking book

The French Banking Federation (*FBF*) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. *FBF* member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

The *FBF* welcomes the opportunity to comment on the Basel Committee on Banking Supervision (*BCBS*) Consultative Document (*CD*) on Interest Rate Risk in the Banking Book (*IRRBB*), aiming at replacing current guidance set out in 2004 *Principles for the management and supervision of interest rate risk*.

The *FBF* supports the responses to the *BCBS CD* by the Joint Association and the European Banking Federation with main messages listed below:

- *IRRBB* management and supervision should be based on behaviour models, including the investment of equity, that are developed by banks so that they are adapted to the different products, jurisdictions, environments and business models in which banks operate; with metrics that are consistent with dynamic / on going management.

The suggested limitations to the duration of non maturing deposits and investment of equity are dramatically too short compared to what is consistent with facts, circumstances and actual management.

- Capital is needed for *IRRBB* only to the extent that it would cover losses due to *IRRBB* and no capital should be needed for variability that would not lead to losses.

The *IRRBB* exposure that would result from changes that do not relate to *IRRBB*, such as a reduction of equity or the assumption of a liquidity stress, should be covered by comprehensive stress testing regulatory framework and not mixed with *IRRBB*-dedicated regulatory framework.

- *IRRBB* belongs to Pillar 2 framework based on binding principles for management and supervision of *IRRBB* with quantitative tests used by supervisors to identify *IRRBB* exposures that may trigger discussions with banks to identify whether or not those exposures should be considered as outlier.
- *BCBS*'s concern about the boundary between the Banking Book (*BB*) and the Trading Book (*TB*) should be dealt with an positive definition of the *BB*, leveraging upon existing banking laws.

- The clarification of the *BB* items shall therefore allow to better understand the purpose of the *IRRBB* management which should necessarily adopt a dynamic / going concern approach rather than a *TB*-derived framework based on a static economic value.
- Considering the above, the *CD* proposals do not fit the purpose and would have detrimental impacts: *IRRBB* supervision would be based on a standardized perception of *IRRBB* that would be at odds with their actual economic *IRRBB*, banks would be incentivized to align their *IRRBB* management along this wrong perception of risk which would lead to higher volatility of their earnings, the capacity to supply fixed rate loans, notably fixed rate mortgages, would be negatively impacted.

Hence, further work should be done to obtain a relevant regulatory framework for *IRRBB*. The ongoing Quantative Impact Study (*QIS*) should be helpful in this additional work. *FBF* is willing to contribute to this work and expect that another consultation will be organized.

Considering the potential impacts on banks and on retail markets as the whole, the *FBF* calls for an early and deep interaction with the *BCBS Coherence and Calibration Task Force*.

A. Standardization of behaviour models would not give a fair representation of *IRRBB*:

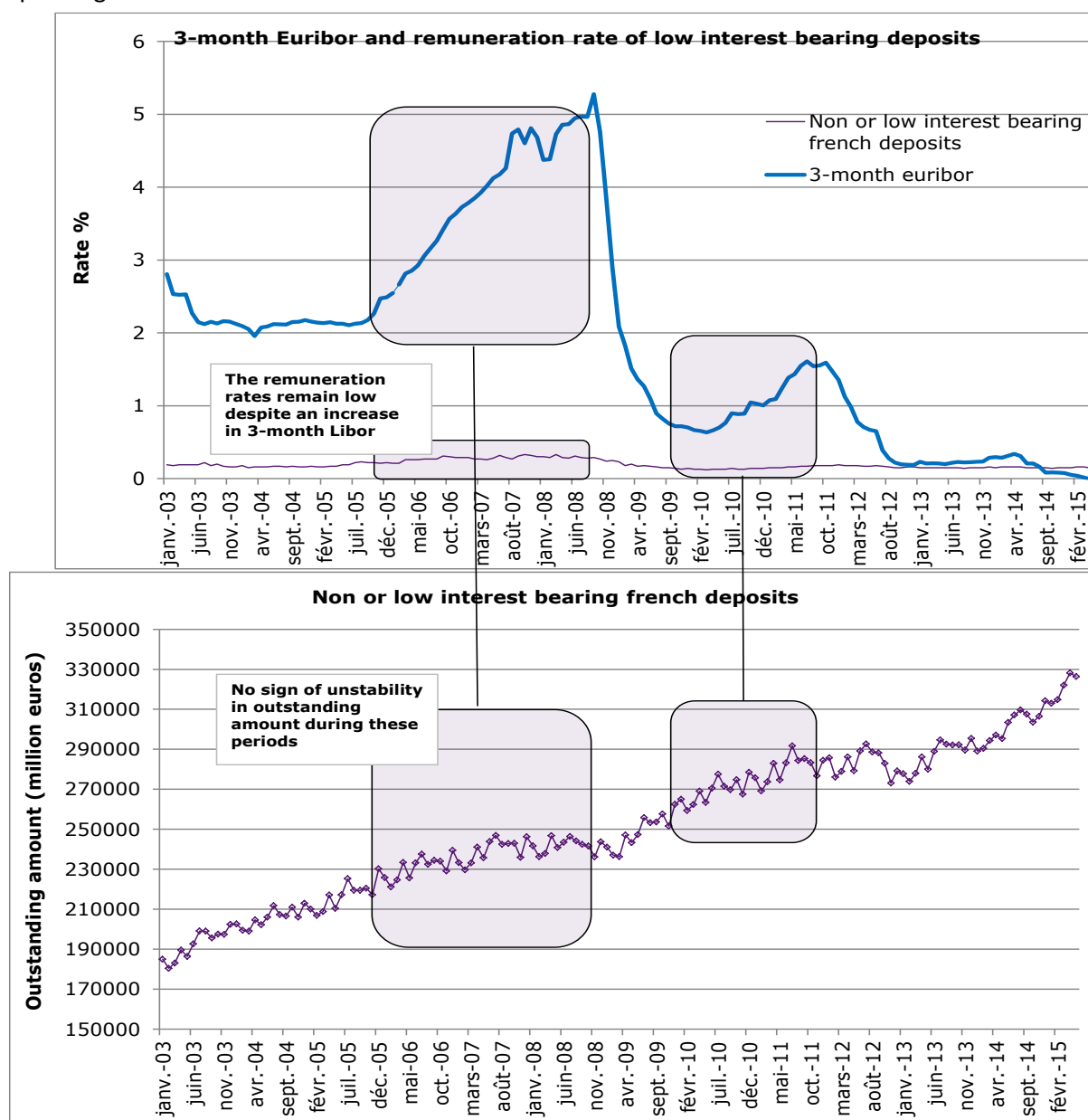
1. Non Maturing Deposits are restricted to far too short durations:

We believe that the proposed standardisation on Non Maturity Deposits (*NMDs*) is not appropriate and the proposed standardization would actually increase the interest risk borne by banks on some deposits.

We believe that the shortening of the *NMD* duration is not a prudent approach for the management of interest-rate risk since it would not fit actual deposit product specificities.

As an illustration, over long period of times, banks have experienced very different environments in terms of rates or liquidity. In France, the outstanding balances on the non interest bearing *NMDs*

Current Accounts) have kept on steadily increasing over time. This is illustrated below over the period spanning from 2003 to 2015¹:



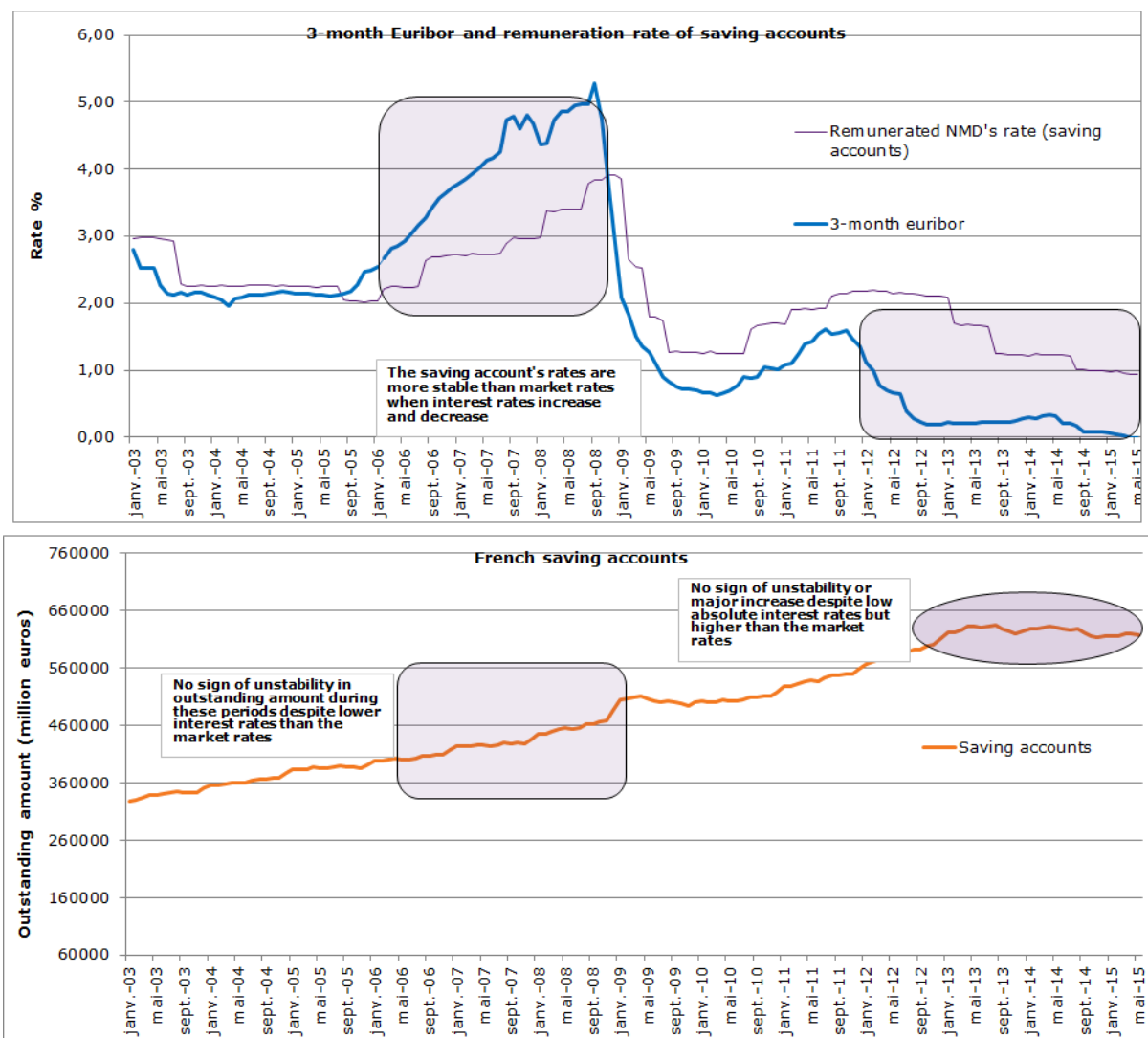
Based on those facts, French banks derive long-term models for these deposits, in line with their strong stability, even in a very different environment. These models have enabled banks to soften the decline in interest rates. Had banks been required to use a short-term models as proposed in the *BCBS CD*, the net interest income would have sharply fallen and French banks would have faced increased difficulties in adapting their cost structure to maintain appropriate operating profit margins.

In France, banks offer special deposit products (e.g. Livret A) whose characteristics are determined by public authorities notably for their tax preferential treatment (some products benefit from lower tax rates). The latter makes those products attractive and their balances stable, and their rates which are either fixed or only partially correlated to market rates. Considering those *must-have* deposit products, banks offer other deposit products whose rates are correlated to public authorities' rates, and that are subject to usual tax treatment.

¹ Sources : Banque de France

The suggested standardization would not be consistent with those products neither in terms of rates or in terms of balance stability.

This is illustrated in the graphs² below on Livret A-related³ deposits which show that both their balances and rates are far stickier than the standardization suggested by *BCBS CD*:



Finally, the definition of *NMDs* should be made clearer.

Hence, we consider that an account where partial withdrawal are not possible and only total deposit withdrawal with a requirement to close the deposit account is not an *NMDs*, since it would alter customer's ability to make future deposits.

As another example, it should be made clear that *NMDs* should only comprise deposits whose rates are set by the banks. Hence, government-administered products should be considered *NMDs* specifically, and modelled appropriately.

These are a few illustrations that any attempt to determine specific category will necessarily be confronted with cases that make the definition difficult to apply, and that flexibility is required to deal with *IRRBB* in terms of management and supervision.

² Sources : Banque de France

³ "Livret A" is a general saving product with a specific tax regime, defined in the French Monetary and Financial Code, that is proposed by all French banks.

2. Investment of Equity:

We think that the regulatory framework for *IRRBB* should recognize that the common practice of the investment of equity enables to stabilize earnings which is a sound and prudent management of *IRRBB*.

The *BCBS CD* proposals simply assume that equity has disappeared, without relating this assumption to *IRRBB*. The potential reduction of Equity, that would derive from the occurrence of non-*IRRBB* risks should be considered in a holistic regulatory framework, such as comprehensive stress tests.

The Economic Value of Equity (EVE) sensitivity that is suggested as a risk metric is not appropriate for measuring *IRRBB* as it assumes a run-off / gone-concern approach, while *IRRBB* is managed in dynamic / going concern approach, notably to make sure that the *structural interest rate risk* due to the re-investment of non- or low-interest bearing deposits and Equity is measured and managed. Any runoff approach, such as any Economic Value-based metric, would fail to cover this essential component of *IRRBB*.

The *BCBS CD* definition of Equity is not clear as it seems to be broader than the regulatory required Common Equity Tier One (*CET1*) and include Additional Tier One (*AT1*) and Tier Two (*T2*). When combined with *EVE* sensitivity metric, this has two odd consequences. First, a higher *CET1* leads to a higher perceived *IRRBB* exposure when it is invested to stabilize earnings. Second, as some of those *AT1* and *T2* instruments are fixed rate instruments, they often are micro-hedged with offsetting fixed rate instruments, such as fixed rate receiver swap, which would appear as naked interest rate risk instruments when using the *EVE* sensitivity metrics.

The articulation between the definition of Equity and how *IRRBB* is measured should be carefully considered.

3. Consequences of too short restricted duration of NMDs and Equity:

The too short duration of non maturing liabilities and equity proposed by *BCBS CD* would be detrimental to the financing of the French mortgage market, as fixed rate mortgage loans represent 80% of the total mortgage loans:

- either banks will be incentivized to stop offering fixed rate mortgages to their customers, if they align their management to the regulatory framework (notably to avoid the penalizing capital charge) ;
- or they will provide higher interest rate charged to customers' assets, if they continue to manage risks with the current economic approach (and suffer from the ill-defined capital charge).

4. Prepayment on fixed rate loans should properly reflect heterogeneous behaviours across different products and jurisdictions:

Behaviour models for prepayable fixed rate loans (and off balance sheet commitments) are very dependent on jurisdictions and business models within which the banks operate. This notably derives different regulatory environments which frame how much prepayment penalties can be charged to customers when they elect to prepay, and the tax treatment of loan interest rate which affect the incentive to prepay.

Any standardized behaviour model would overlook facts and circumstances and would lead to either over estimation of prepayment (resp. drawdown) or under-estimation of prepayment (resp. drawdown). The proposed framework would simply not be risk based which discards it from being an appropriate regulatory framework.

Banks should apply the behaviour models that fit facts and circumstances, and which enable to forecast prepayments and drawdowns in each interest rate scenario.

The suggested framework also fails to consider that a portion of prepayment does *not* relate to interest rates but to events that are behavioural or even sociological (e.g. move, divorce). Those factors are very much jurisdiction-dependent and could not be standardized.

B. Main objections to BCBS CD proposals to derive capital for IRRBB

1. The BCBS CD proposals to identify and measure need for IRRBB capital based on EVE variability are fundamentally flawed:

The approaches proposed in the *BCBS CD* to measure the potential need for capital due to *IRRBB* are based mainly on *sensitivities* to changes in interest rates of Economic Value of Equity (*EVE*) and of Net Interest Income (*NII*).

The FBF strongly believes that capital for *IRRBB* is needed only to the extent that there is a risk of loss due to *IRRBB*. As sensitivity-based metrics do not enable to identify *loss risk* but only *variability risk*, they fail to identify potential need for capital due to *IRRBB*-driven loss. Hence, **all the metrics in options 1 to 4 suggested by the *BCBS CD* are fatally flawed by being *variability risk*-based and not *loss risk*-based.** This fatal flaw is compounded by using standardized behaviour that are at odds with actual *IRRBB* exposures.

As mentioned above, the use of *EVE* sensitivity as the main metric implies a runoff / gone concern approach which leads to consider that the investment of own funds on fixed rate assets automatically generates a risk, without recognizing the contribution of such a strategy in terms of future income stabilization. More generally, Economic Value-based metrics fail to consider the *structural interest rate risk* and are at odds with actual *IRRBB* management which aims at stabilizing earnings, as stated in paragraph 4.2 of the consultation (page 8).

We hold the view that a sensitivity of the Economic Value approach is not in line with the aforementioned objective of most commercial banks when it comes to a basis for the development of a supervisory model for capital measurement to identify loss risk.

NII that is considered in the *BCBS CD* is based on a static approach and is actually the first year bucket of the (runoff-) *EVE* (which leads *BCBS CD* proposal to count twice the first year component of *EVE*). Once again, a static analysis does not take into account the bank's exposure to *structural interest rate risk* originating from non- or low-interest bearing (low pass-through rates) funding sources

NII should be calculated in dynamic approach of the banking book, including *structural interest rate risk*, with banking book items taking into account the effects of each considered interest rate scenario on customer rates, balances (e.g. prepayment) and potential changes in mix of the balance sheet (e.g. change from a deposit product to another due to interest rate changes). Those *NII* forecasts should cover several year horizon (typically 3 to 5 year horizons).

The *NII* forecasts enable identifying the potential loss due to *IRRBB*, that would need to be capitalized.

We recommend that dynamic / going concern *NII* forecasts are used to identify potential loss due to *IRRBB* in one of the pre-defined interest rate scenarios.

2. The suggested interest rate shock scenarios that are proportional to current level of interest rates would create very volatile capital requirements:

We are of the view that it is not appropriate to provide for shock scenarios that are proportional to the current level of interest-rates as specified in the *CD*.

In the current low interest-rate environment, it would result in a shock equal to the floor (i.e. 100 bp). However, in case of an increase in interest-rates, the required shocks would rise and may even reach the maximum of 300 bp. Such an approach would result in volatile capital requirements.

We recommend implementing interest-rate shocks linked to the historical volatility on absolute change of interest rate (and not relative) which would not be proportionate to the current interest-rate levels.

C. The *IRRBB* regulatory framework should remain within the Pillar II framework

The *FBF* support a Pillar II approach that is based on:

- **Principles for the management and the supervision of *IRRBB***, covering strong corporate governance notably on models that are needed to properly measure *IRRBB* exposures, and on the boundary between *BB* and *TB*;
- **Outlier Tests to identify potential outlier *IRRBB* exposures**, without automatic supervisory decision, notably capital charge, between the risk measurement and any potential capital requirement;
- **Identification of potential need for internal capital for loss due to *IRRBB*** based on dynamic / going concern metric for measuring *IRRBB*;
- ***IRRBB* should be considered in the comprehensive stress test analyses** which combines different sources of risks

❖ Principles for the management and the supervision of *IRRBB*

We stress the importance of **effective corporate governance**, policies and procedures, risk measuring and monitoring systems, stress testing, and internal control related to the *IRRBB* exposures of banks. In addition, by (i) subjecting *Internal Measurement System – IMS* for capital adequacy to supervisory review (not pre-approval), and (ii) amending the Pillar II Principles, the Pillar II approach will largely be enhanced, notably for the governance on *IMS* (which should include the choice of investment of equity).

To address the *BB* vs *TB* boundary issue, that is not covered by the *BCBS CD* though it is mentioned as one of the reasons for this initiative, it is necessary to understand the nature of the *BB* exposures, the related interest rate risk and the differences with the *TB*.

The *BB* is essentially composed of:

- Financing-intermediation items such as loans, deposits and financing commitments;
- Corporate-like balance sheet items such as capital, equipment and premises;
- Financial instruments:
 - Investments : transactions that are originated to be held to their maturity;
 - Risk mitigation transactions : derivative transactions in the *BB*, most will qualify as accounting hedges (fair value hedge or cash flow hedge) but occasionally some cannot be accounted for as hedging instrument and are accounted for held for trading even though the intention is to hedge a banking book exposure.

Most of the *BB* items are *not* traded and could not be part of the *TB* (i.e. there is no boundary issue). Their economic value that can be calculated from discounting expected cash flows of existing transactions may be useful but remains theoretical since those values are not subject to market prices. Indeed, the very nature of the intermediary function of the bank is to adopt an on-going business model. It is not comparable to a *TB* where value can be terminated by simply the products.

Some financial instruments (bonds, derivatives) used in the banking book are accounted for as Fair Value in the balance sheet and either accrual through Profit and Loss (cash flow hedge and available-for-sale, fair value hedge) or fair value (when hedge accounting is not possible for derivatives). Those instruments are executed with the intent to mitigate an *IRRBB* derived from the bank performing its traditional bank-intermediated-financing functions (borrowing from agents with liquidity surpluses; lending to agents with liquidity deficits) and not with a trading intent. To this end banks have robust systems and controls in place to monitor that no trading intent exists (e.g. policies, procedures and governance) both before the fact and after the fact.

The measures put in place under the *Fundamental review of the trading book - FRTB* aim at ensuring a strong governance process for classification into *BB* or *TB*, including limitation of transfer between the two books to exceptional circumstances. Those measures, strengthened with further measures put in place in the context of structural reform of the banking industry will sufficiently address any potential arbitrage between the *BB* and *TB*.

We believe the differences in the nature of the *IRRBB* and the *IRRTB* need to be fully understood when designing the capital framework to avoid any unintended consequences (namely a reduced capability to lend to the economy and/or an increase in costs passed to customers) resulting from application of the same capital treatment regardless of the nature of the IRR.

Alignment of the capital charge for *IRRBB* with the capital charge for market risks in the *TB* with the aim to avoid arbitrage would not be sensible due the very different nature and purpose of the trading book and banking book.

❖ Outlier Tests to identify potential outlier *IRRBB* exposures

We recognized that **quantitative tests** would be used for supervisory purpose to identify potential outlier exposure and to trigger a deeper analysis based on risk-sensitive economic risk framework.

The *FBF* agrees that the *sensitivities* of *NII* and of *EV* of the *BB* to pre-defined shocks of interest rates could be used to help identifying banks that could have *IRRBB* exposures that would appear to be outlier. However, it should be clear that **no automatic capital charge would be decided from the outlier tests** (notably due to the fact that they don't relate to loss risk).

Material identified weaknesses in risk management processes or high levels of *IRRBB* exposure would require corrective action such as reduce levels of IRR exposure or raise additional capital.

❖ Identification of potential need for internal capital for loss due to *IRRBB*

Internal capital should be allocated 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**. The **identification of loss risk should be based on earnings forecasts**, for different interest rate scenarios, over a several year horizon (e.g. 3 to 5 year horizon). Earnings forecasts should be based on bank-adapted models, subject to strong governance as articulated in the suggested Principle #6 and that supervisors have access to through their usual review process (Supervisory Review and Evaluation Process, *SREP*).

Interest rate scenarios would cover sufficiently diverse and plausible interest rate scenarios (with a determined confidence interval level). Capital would be needed to the extent that one of those specified scenarios would lead to negative *NII*.

For this calculation, the future earnings should be calculated over a several year horizon, on a dynamic / going-concern basis consistent with each envisaged interest rate scenario based on models developed by the banks and adapted to its operating environment with customer rates, prepayment, potential changes in balance sheet mix attributable to interest rate that should be taken into account for each considered interest rate scenario.

❖ ***IRRBB* should be considered in the comprehensive stress test analyses**

Changes or events that would not be driven by interest rates, such as credit risk event, reduction of equity... that could have second round effect on *IRRBB* should be considered 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. 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 Single Supervisory Mechanism.

Hence, it is unnecessary and it would be inconsistent to include non-interest rate-driven events in the *ICAAP* for *IRRBB* process.