

Comments

on BCBS Consultation Paper “Recalibration of
shocks for interest rate risk in the banking book”

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On December 12, 2023, the Basel Committee on Banking Supervision issued the consultative document “Recalibration of shocks for interest rate risk in the banking book”. We appreciate the opportunity to comment on the consultative document and are pleased to submit our comments in the following.

We consider a regular inspection of the calibration of interest rate shocks for interest rate risk in the banking book (IRRBB) at certain intervals to be appropriate. We can understand the new methodology presented here better than the methodology in the IRRBB standard (BCBS 368). Nevertheless, we would like to suggest improvements that better reflect the economic reality for the management of interest rate risk.

We note that the new consultation paper is proposing comprehensive methodological changes to derive the interest rate shock parameters. These relate to:

- removal of the global shock factors and introducing local shock factors
- extending the time series with a holding period of six months
- increasing the percentile value from 99% to 99.9%.

The proposed new methodology is also designed to address the existing methodological weaknesses in the derivation of interest rate shock parameters (e.g. switching to local shock factors). On the one hand, we welcome the fact that the expansion of the time series is accompanied by a switch from relative to absolute interest rate changes as the basis for calibration.

On the other hand, we oppose the proposed increase of the percentile value. The further exacerbation of interest rate shocks that this would entail would further restrict the effective management of interest rate risk and force banks to enter into transactions that are not necessary or are even harmful from a management perspective. Even if exceeding the SOT thresholds does not automatically trigger supervisory measures, including the SOTs in the management of the banks can nevertheless be expected and required by the supervisory authorities.

A more detailed description would also be desirable to allow a better understanding of the effects of the individual adjustments. In particular, what appears to be missing here is any differentiation after extension of the history and adaptation of the methodology, including for the 99% percentile value, as well as an additional illustration of the as yet unrounded results for all analyses.

We would like to comment in detail in the following:

Removal of the global shock factors and introducing local shock factors

In principle, the interest rate shock scenarios should aim to achieve comparability between institutions at the national and international level. We think it makes sense to link the interest rate shock scenarios to the interest rate level of the relevant currency. The derived interest rate shock parameters should generally correspond to the local macroeconomic conditions (interest rates, yield curves, inflation, power of the central bank, money supply tends, etc.) for all currencies. It should be noted that these specifications are defined for several years. Significant differences in the magnitude of interest rate shocks could lead to distortions of competition. Depending on the observation period, the chosen methodology will necessarily lead to distortions. There are different shock levels for EUR and USD, for example, depending on the time series or the timing of the analysis, although interest rate levels and

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trends do not actually differ fundamentally in the long term. The results of the recalibration again penalise the EUR banks. Due to the massive rise in US interest rates – including in comparison to EUR interest rates and in light of the IRRBB problems at US banks – we do not understand, on the whole, why the parallel shock for EUR even increases to 250 bp, but stays at 200 bp for USD.

It is also important to bear in mind in this context that adjusting the interest rate shocks has far more profound consequences in some jurisdictions than in others. In the EU, interest rate shocks in particular form the basis for the supervisory outlier test on economic value of equity (SOT on EVE), which will even be supplemented in future by a periodic counterpart (SOT on NII). By contrast, other jurisdictions have not even implemented an economic value of equity outlier test. The fact that, at the same time, EUR shocks are expected to rise particularly sharply compared with other currencies would therefore penalise EUR banks several times over. It needs to be noted that the institutions affected by this demonstrated good IRRBB management during the banking turmoil in 2023 and proved their resilience to interest rate shocks. For example, no German institution was exposed to interest rate risk in such a way that it impacted the institution as a going concern.

Rounding

In addition, the extremely approximate rounding to the nearest multiple of 50 basis points leads to distortions and runs counter to the Basel Committee’s intended approach of making calibration more precise and hence more appropriate in individual cases. We are therefore calling for rounding to a multiple of 25 basis points. This also corresponds to the usual key interest rate changes made by central banks in increments of 25 basis points.

Extending the time series with a holding period of six months

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

In the case of continuously increasing time series histories, all interest rate changes for the given percentile value would always be used by design. Extreme events would be collected in the time series history and permanently influence the results, which would represent an extremely conservative approach. In this case, extremely old information could potentially determine current and medium-term management triggers. However, the informative value of interest rate time series data for simulating interest rate shocks decreases over time.

Instead of allowing the length of time series to keep on growing, we propose modifying the history to be included to be a defined, constant rolling time window of 20 years. The data from January 2003 to December 2022 could be used to effectively validate the interest rate shocks to date. This approach recognises that the underlying economic reality is decisive, especially for the risk-free interest rate time series that are relevant here. A 20-year time series length typically includes several economic cycles and

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crises. Another advantage of a constant time window is that the existing parameters can be reviewed to test their robustness. The signal to increase the interest rate shock parameters, keep them constant or reduce them is clearer.

In our opinion, however, 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 interest rate risks in the banking book, even in an interest rate shock. Instead, the open risk positions can be closed within a few days in line with management decisions. A time window of six months to simulate an adverse yield structure taking effect overnight is therefore far too long and unsuitable in practice for a pure interest rate risk simulation. The interest rate scenarios to be derived must relate to interest rate risk management. The result therefore constitutes an extreme scenario, which is not appropriate on account of the high degree of conservatism and not suitable for economic management. Stress tests are also performed as part of the ICAAP with the result that crisis scenarios are also covered by the institutions. An assumed adjustment speed of three months for the supervisory shock scenarios is therefore sufficiently conservative.

Switch from relative to absolute interest rate changes

The consultation paper continues to use the previous assumption of a six-month holding period to calibrate the interest rate scenarios. Under the current IRRBB standard, the relative interest rate changes are calculated prospectively on the basis of a rolling six-month time window. In the proposed new methodology, however, absolute six-month differences in interest rates are calculated retrospectively. We welcome the switch from relative to absolute interest rate changes as the basis for calibration, as this circumvents the problem of high relative changes in interest rates close to zero.

Increase of the percentile value from 99% to 99.9%

The choice of the percentile value significantly influences the magnitude of the interest rate shock. In the adjusted 16-year time frame (from January 2007 to December 2022), our analysis shows that the 99% quantile for the euro area confirms a parallel shock of 200 bps (the actual value is 209 bps). In the extended time window in the BCBS consultation paper, the 99% quantile also exactly matches the previous parameter, at 199 bps.

We oppose increasing the percentile value from 99% to 99.9%. This results in extreme scenarios that are not suitable for adequately assessing interest rate risk in the banking book. The interest rate shock scenarios should continue to be distinguished from a maximum drawdown, not least because the institutions also calculate their own stress tests.

The proposed new interest rate shock parameters in EUR do not increase solely as a result of the simple extension of the time series, but significantly because of the increase of the percentile value from 99% to 99.9%. We cannot follow the justification for the blanket methodological switch to a 99.9% percentile value. In our opinion, a reference to maintaining “a sufficient level of conservatism” is not sufficient as a technical argument. There is no quantitatively substantiated justification as to why the current level of conservatism is not sufficient. According to the explanations in the consultation paper, the scenarios would also be tightened in the 99% quantile for the EUR area, which in itself results in a higher level of

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conservatism compared with the previous parameters. Moreover, the Basel standard on IRRBB generally already contains a sufficient number of conservative components, meaning that the percentile value does not additionally need to be increased from 99.0% to 99.9%:

- Extending the time series generally tends to lead to higher shocks (see above).
- The higher of the shocks up and down is automatically applied as the new shock value to recalibrate the supervisory shock scenarios, without any justification being given. For EUR, a 99% quantile would actually result in the following shock levels:
 - Shock down: –191 bp (rounded: –200 bp)
 - Shock up: +161 bp (rounded: +150 bp)

The higher shock down of –200bp would also be applied as a shock up with a reversed sign, although the time series would actually result in a significantly lower absolute value.

- The new SOT (formerly early warning indicator in Germany) is already significantly more conservative than the old SOT (now: 15% of Tier 1 capital v. before: 20% of own funds in the case of SOT on EVE; also worst value from six instead of two shock scenarios).
- The derivation of ad hoc interest rate shifts from 6-month changes means that a hypothetical extreme situation already serves as the basis for the supervisory assessment of the banks’ general interest rate risk situation and for the banks’ own interest rate risk management.
- For institutions with foreign currency positions, a very high level of conservatism is already achieved by recognizing 100% of losses, but only 50% of gains. Combining this with a percentile value of 99.9% for derived interest rate shocks results in increasingly erratic results. The observations at the periphery of the distribution in different currencies should not differ even more than they do at the 99% percentile value.

Additional note: Effects on the implementation of the SREP in Germany

We also need to consider the consequences on the country-specific implementation of the SREP. The stricter quantile also has consequences for the German supervisory authority’s SREP bucket logic. The SREP buckets were previously calibrated at 99.0%, which is already very conservative. When risk-bearing capacity was switched to the economic perspective, a conversion factor of 0.8 was introduced to take account of the increased conservatism in the bucket approach. This conversion factor or some other adjustment is then also likely to be necessary for interest rate risk in the banking book. The higher stress test results from the interest rate shock scenarios could result in higher capital requirements for the institutions under the SREP if the excess risk from the Pillar 1 and Pillar 2 comparison of interest rate risk is not adjusted.