

Comments

on BCBS Consultation Paper “Interest rate risk in the banking book” (BCBS 319)

Register of Interest Representatives

Identification number in the register: 52646912360-95

Contact: Olaf Wegner

Telephone: +49 30 20225- 5408

Telefax: +49 30 20225- 5405

E-Mail: olaf.wegner@dsgv.de

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

Coordinator:

German Savings Banks Association
Charlottenstrasse 47 | 10117 Berlin |
Germany

Telephone: +49 30 20225-0

Telefax: +49 30 20225-250

www.die-deutsche-kreditwirtschaft.de

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I. General remarks

We basically acknowledge the Basel Committee's initiative to strive for an improved comparability between institutions at the national and the international level with respect to interest rate risks in the banking book. In addition to this, the Committee's proposal is made to limit the incentives for capital arbitrage because of the very different treatment of the banking and trading book. However, this is of no relevance especially to those institutions that carry out trading transactions to just a minor extent, usually stay within the European minimum limits according to Art. 94 CRR and, accordingly, are not trading book institutions. This should entail a relief with respect to the capital requirements.¹ In our opinion, the existing restrictions regarding capital arbitrage between banking book and trading book are already sufficient.

Basically, we understand the Committee's objectives because we also regard interest rate risk as one of the essential risks banks are exposed to. However, in the more recent past this risk has not been relevant to any German bank in a way that had a substantial effect on its existence. The currently applied Pillar 2 prudential standards are an appropriate and sufficient set of rules. The most recent financial crisis has clearly shown how advantageous it was that uniform standards for the management of interest rate risks have not yet been developed in the industry. An optimal interest rate risk management system needs to be adjusted to its particular business model. With the interest rate risk coefficient² and the so-called test criterion of the German supervisory authorities, well established indices for sufficient comparability are already in practice. With this internally developed test criterion, the German supervisory authorities ensure that the institutions have sufficient equity capital to cope not only with the credit risk and operational risk but also with interest rate risks. If this test criterion is met, the German supervisory authorities decide on a case-by-case basis whether interest rate risks need to be backed by additional capital or not. A similar methodology would be conceivable as an international standard.

We believe that the development of a standardised regulatory model for the regulatory capital treatment of interest rate risks in the banking book is neither possible nor necessary. Quite the contrary: to our point of view, a regulatory standard approach is even dangerous. Standardisation will impede the independent further development of the business models. We see the danger that due to this, only the interest rate risk management model created by the supervisory authorities will prevail. However, such a model by far cannot meet the economic requirements because it does not consider any bank-specific circumstances such as risk profile or business model.

For this reason, we appreciate that the Basel Committee has not yet finally decided to introduce a standardised Pillar 1 capital framework. However, we are likewise critical of the introduction of the standardised regulatory model in an enhanced Pillar 2 approach. We expect that the existence and application of mandatory standardised calculation methods in itself and the existence of a permanently calculated fallback solution will possibly result in inappropriate capital requirements and, as a consequence, in false management considerations. Moreover, an obligatory parallel calculation of the standardised Pillar 1 model would cause high technical and ongoing procedural requirements which would not have any recognisable additional benefit for the individual bank or the stability of the financial system. The approach described in the consultative document cannot be implemented with the existing,

¹ In detail, the minimum limits according to Article 94 CRR are: The extent of balance sheet and off-balance sheet trading book activities usually is less than 5% of total assets and less than EUR 15 m, and it never exceeds 6% of total assets or EUR 20 m.

² Coefficient derived from present value change (as a consequence of a 200 basis point interest rate shock) and equity capital amount.

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clearly more developed, systems specifically tailored to manage interest rate risks. Therefore, reprogramming and new processes within the institutions are required, associated with additional effort.

Furthermore, the present consultative document stipulates the supervisory authorities to apply additional capital charges for interest rate risk to a larger extent. Hitherto, banks have rarely faced such additional capital charges. Accordingly, this would mean an additional burden without the institution's risk having actually changed. We, therefore, reject this proceeding.

We clearly welcome that the Basel Committee does not further pursue capital requirements for credit spread risks in the banking book in the context of the standardised regulatory model (Pillar 1). However, according to the proposal of the Basel Committee, credit spread risks shall be considered in Pillar 2. Up to now, in Germany capital charges for CSRBB are very limited. They only apply within the EVE framework and only for fungible securities featuring a market price. Loans for which valid market information regarding the credit spread risk associated with the borrower is not available, need not to be taken into account. Migration risk is analysed as a separate aspect of credit risk. The risk amount to be applied is appropriately corrected in case of demonstrable overlapping with credit spread risks.

Moreover, the paper should provide more clarity on the definition of credit spread risks. These risks should be treated based on the existing pattern. We oppose the consideration of credit spread risks in Pillar 2 going beyond the existing extent. Credit spread risks are already taken into account in the context of credit risk management. Any consideration within the interest rate risk framework would, therefore, not be justified. Furthermore, taking account of past experience, there is no material common cause or interdependence of the two risk types.

As explained above, uniform standards for the measurement and management of interest rate risks have not been developed in the industry for good reasons. Already at present, different measuring methods are used complementarily to take into account both the effects on revenue as well as on equity and the financial situation of the institution. All methods have in common the challenge that assumptions regarding the interest rate adjustment behaviour in retail banking need to be made on both sides of the balance sheet for items without fixed interest rates and capital lockup. Standardisation would enforce universal assumptions for all institutions, although the interest rate adjustment behaviour is extremely heterogeneous. This would entirely neglect the respective behaviour in different regions and customer groups. Accordingly, universal assumptions, as a necessary precondition to standardisation, are in principle not adequate to the individual risk profiles of the institutions for several reasons:

- If the institutions, for their customer products, retain the parameter definitions they have optimised for the business models and if the supervisory authorities, based on their specifications, determine the interest rate risks in a way deviating from this, then the regulatory interest rate risk does not correspond to the institution's actual interest rate risk. Hence there is no economically reasonable comparability between the interest rate risk calculations of different institutions.
- If the institutions, for setting the interest rates for their customer products, retain the parameter definitions they have optimised for the business models and determine the interest rate risks in a way deviating from this in compliance with regulatory standardised specifications, then the calculated interest rate risk does not correspond to the economic interest rate risk. An additional model risk is created in that the customer margins determined in the calculation might not be received in disposition.

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- If the institutions adjust the parameter definitions that they have optimised for the business models according to the regulatory standardised specifications, this entails a changed behaviour in the capital and customer markets. Long-term fixed interest rates will become less important. This will result in destabilisation of long-term corporate financing and especially affect Germany's small and medium-sized businesses.

In our opinion, the increased importance of regulatory measures for interest rate risk assessment creates clear incentives to align internal management and, consequently, customer product policy, with regulatory requirements. Instead, it should be tailored towards the bank's specific risk profile and customer demands. Due to the standardised methods and assumptions, this might generate inappropriate management stimuli. In particular, we fear inappropriate capital requirements with regard to the risk, the compulsive risk-inadequate hedging transactions, increased earnings volatility due to transactions and product policy adjustments motivated by regulation, a reduction of the low-risk business due to very much reduced profitability, a concentration process with respect to the business policies, less competition and hence an increase of systemic risk and shorter fixed interest rates in the lending business.

The proposed standardised model would have far-reaching effects. Banks would no longer be able to offer savings products to their customers which are largely independent of the interest rate level or which simply follow the interest rate level very sluggishly, because regulatory requirements do not admit or do not acknowledge long maturities for variable savings products. At the same time, inadequate capital requirements have undesirable consequences for the supply of credit to the economy and hence for the economic development of the entire national economy.

Over-regulation of the banking sector might, moreover, promote "shadow banks". Unequal competitive conditions between the banking sector and other enterprises that offer financial services lead to a growth of shadow banks, so that they might become systemically-relevant in the foreseeable future. In the USA, shadow banks are presently providing more than half of the entire credit volume.³ In the euro zone, that share is presently about one fourth, but the trend is upward.

Until now, the supervisory authorities have asked the institutions – which we represent – to develop methods reflecting the interest rate risk in Pillar 2 that are as far as possible adjusted to their business strategy/policy. With the presented standardised models in Pillar 1 or the fallback solution in Pillar 2, the developments go into the opposite direction.

For the reasons explained, we reject the regulatory proposition regarding the capital requirements of interest rate risks in the banking book presented for consultation. Instead, we prefer a revised Pillar 2 approach which should be strengthened and improved by the further development of the validation of the institute-specific methods (analogous to the IRB model validation carried out by the national supervisor). We do not see the need for the explicit acceptance of the institute-specific methods by the supervisory authorities because the methods are reviewed in the context of the ongoing supervision and suitable supervisory measures may be taken in the case of any inadequacies (SREP). In our opinion, capital requirements in Pillar 2 based on individual calculations cover the institutions' interest rate risks most appropriately. We oppose the specification of standardised calculation rules and the parallel calculation of the fallback solution from the Pillar 1 approach.

³ Cf. International Monetary Fund (2014), Shadow Banking Around the Globe: How Large, and How Risky?; page 67

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The German Banking Industry Committee speaks out in favour of the greatest possible conformity of internal and regulatory processes to minimise, as explained above, wrong incentives regarding the potential risk treatments and to keep the additional effort caused by parallel measuring methods as low as possible. The leeway for the banks' internal methods acknowledged by the supervisory authorities must be appropriately large. Parallel application of different models will inevitably result in difficulties of interpretation and hence wrong management stimuli. This should not be intended by supervisory authorities.

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II. Special remarks

Risk measurement methods

In the methods existing and established in practice, the four components of interest rate risk (parallel gap risk, non-parallel gap risk, basis risk, optionality risk) are normally not calculated separately as described in Section I Subsection 4.1 of the consultative document. Nevertheless, all the mentioned effects are contained in the current applied risk models. Assessing the four partial risks separately causes considerable additional effort, with the added value being unclear at the same time. We deny the necessity of measurement at the level of these partial risks.

The proportionality principle formulated in Section III Subsection 2.3 of the consultative document at least should be extended also to the aggregation level of risk calculation and take into account that splitting the interest rate risk is not necessary for small or noncomplex institutions.

Section I Subsection 4.2 of the consultative document deals with the duality of earnings-based and economic value measurement methods. We oppose preferential treatment of the one or the other measurement approach and ask for an orientation towards the institutions' individual needs.

We also reject the standardised Pillar 1 approach set out in Section I Subsection 4.4 of the consultative document and the presented enhanced Pillar 2 approach. Standardisation for the measurement and management of interest rate risks is not possible for the reasons already explained in the general section above. We believe the existing regulatory practice is fully sufficient.

We welcome the committee's proposals made in Section I Subsection 4.5 regarding the partial recognition of internal methods: standardised methods are not sufficient to capture the heterogeneity of the risks. These reflections are also conform to our general criticism of standardisation. However, the conclusions drawn from the reflections are not sufficient at all.

Cash flow bucketing

The represented cash flow bucketing based on maturities is an outdated method which does keep up with to the requirements of today's risk measurement systems. In many institutions, interest rate risks are managed using an overall bank cash flow. The proposed regulation should absolutely not require all institutions to value and quantify the interest rate risk by using time buckets. The grouping in time buckets involves a substantial loss of accuracy compared to the direct application of the overall bank cash flow.

If cash flows have to be grouped in time buckets, it should be taken into account that established mapping methods preserve both the economic value and the risk of the actual cash flow. Moreover, we point out that in particular large banks today no longer have a cash flow data basis at all but calculate sensitivities on a daily basis.

We, therefore, speak out against the method described because it is a clear step backwards and would involve enormous implementation costs.

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Interest rate shock scenarios

We consider a link of the interest rate shock scenarios to the interest rate level of the respective currency as reasonable. In addition to this, fundamental requirements should be applied to the resulting yield curve. It is necessary to ensure that the resulting "shocked" yield curve is arbitrage-free. Furthermore, the resulting yield curve should not be entirely unrealistic – e.g. because of unreasonable steepness. Moreover, it is not clearly specified how yield curves shall be treated which were (partly) already negative prior to the simulated interest rate shock. In the event of a negative interest rate, the floor should not be at zero but remain at the existing negative interest rate.

With respect to the number of the scenarios, a limitation to the necessary extent is important. Even with good technical support, any simulation involves high technical effort. In our opinion, the six scenarios proposed are fully sufficient for simulation.

We welcome that the consultative document provides for a significance threshold for the separate assessment of foreign currency positions in the banking book. 5% is a reasonable figure below which a separate calculation of currency-specific interest rate shock scenarios is not necessary. We assume that minor currency positions are instead to be measured uniformly with the home currency interest rate shock scenarios.

For calibrating the interest rate scenarios, the consultative document assumes a holding period of six months. In our opinion, this rolling window for the determination of the scenarios considerably diverges from the period which is actually required to close interest rate risks in the banking book even in the case of an interest rate shock. In reality, the open risk positions can be closed within a few days if needed. A rolling window of six months is, therefore, far too long for an interest risk simulation overnight and an uncommon practice. The interest scenarios to be derived must match to the holding period.

With reference to the definition of the interest rate changes under stressed conditions, we welcome the inclusion of a cap. However, we believe that the caps of 300 basis points to 500 basis points are far too high. Even in the past, at a clearly higher interest rate levels, e.g. in the euro interest rate curve, jumps of that size have not been observed, even over a longer period such as one year. A cap at 200 basis points or lower (+130 basis points as applied until 11/2011 were fully sufficient) appears to be clearly more adequate.

We would welcome if the national supervisory authorities defined and published scenarios adjusted to the current situation on a yearly basis. This eliminates the need for the very complex determination of the interest rate shock scenarios for each institution. Extremely high and unrealistic shock parameters resulting from the transfer of volatility from the current low-interest-rate environment to other points in time must be avoided when defining those scenarios.

Possibly, part of this problem can be solved by introducing relative and absolute caps and floors but with very general specifications, unforeseen constellations can never be ruled out.

Non-maturity deposits

In our opinion, the approach set out in Section II Subsection 2.5 of the consultation paper and the segmentation made primarily base on capital lockup. Capital lockup is the basis for liquidity risk. For interest rate risk, the repricing speed should be regarded as the basis. The slower the product interest

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rate adjusts to market interest rate changes, the more stable the moving average of interest rates used to model the NMDs needs to be. Only in this way the interest rate risk can be mapped adequately – and moving averages are the more stable, the longer the term of the underlying interest rate is. This approach is not taken sufficiently into account in the consultative document. Although the consultative document addresses interest rate adjustment, it de facto focuses on liquidity. Based on our experience, the assumptions made regarding interest rate responsiveness/sensitivity are wrong. We, therefore, believe the approach is not appropriate.

Liquidity risks are already regulated in context of Liquidity Coverage Ratio and Net Stable Funding Ratio and hence should not be part of the interest rate risk framework.

In addition, we point out that the correct modelling of non-maturity deposits (NMDs) is the significant element of interest rate risk measurement in the banking book. In Germany, according to Bundesbank statistics of May 2015, the overall volume is at least some 2.3 billion euros (measured based on sight and savings deposits), which are available to the institutions for funding. The possibility of an institution to adequately map the volume, the duration of deposit and the interest rate responsiveness of this funding source is one of the decisive competitive factors and must not be restricted unreasonably by regulatory requirements.

For this reason, banks usually have many years of experience in the modelling of NMDs and appropriate model validation. Various modelling methods exist. They all have in common that the respective products are classified into groups or clusters which are as homogeneous as possible, based on assumptions regarding the necessary interest rate adjustment behaviour. In practice, sales and product strategies are reflected in the clustering, which is determined by the type of the products, legal peculiarities, markets and the planned interest rate adjustment behaviour. Finding an optimal clustering is a major challenge. The volumes of the deposits in the different clusters are modelled on the basis of historical observations, taking account of the speed of the deposit volume increase and of seasonal effects or campaigns, assumptions regarding the future interest rate adjustment behaviour and expert estimates. The clustering is institution-specific and stress-tested and validated on a regular basis.

The distinction made by the supervisory authorities in the Time Series Approach (TIA) into only two customer groups (corporate and retail customers) or into "transactional" and "non-transactional" is completely inadequate and – even if differentiating between interest rate and liquidity risk – not appropriate. It means a significant step backwards both with regard to the supervisory assessment and the banks' management of interest rate risks. The defined distinction does not provide the required high level of homogeneity within the individual customer collectives or groups.

Furthermore, we believe the specification of an average, let alone maximal term is detrimental because the average maturity and the interest rate fixing of NMDs are determined by the bank's product policy and reflect the planned interest rate adjustment behaviour. The determination of the interest rate adjustment behaviour is part of the corporate strategy and, therefore, must not be restricted by a standard. The implementation of rigid standards would result in a permanent duality and a divergence of "regulatory" risk and "actual" risk, with an improved likelihood of mismanagement because the actual risks are not adequately measured. Management decisions such as regarding the hedging of interest rate risks or the changing of the terms and conditions for additional deposits are – in order to reduce capital requirements – based on wrong assumptions regarding interest rate adjustment behaviour and also result in volatilities and distortions with an effect on profit and loss. In an extreme case, the result is an

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adjustment of the terms and conditions by the institutions that follows the interest rate risk calculated according to regulatory requirements - and not the other way round. For these reasons, it is necessary that all institutions have the option to continue using their established internal methods and their parameter definitions adapted to their individual situation in a possible regulatory approach. Moreover, there is the danger that optimisation of capital backings is strived for by reducing the maturities in the lending business and hence the customers' requirements are no longer adequately taken account of.

The limits defined in the consultative document regarding the determination of so-called "core" deposits, the only part that may be modelled beyond an interest rate fixed for one day, are intolerably high. For example, it is assumed even for the historically most stable deposits as regards volume and interest rate, i.e. consumer sight deposits, that at least 40% of the volume are "non-core" and hence reprice after one day. To make things worse, the "core" share of the deposits shall be modelled with a maximum maturity of only six years and hence with a maximal average maturity of three years. This very much restricting parametrisation is completely contrary to the institution-specific models developed and validated over a long time. These models in particular for non-interest-bearing deposits have very long effective fixed interest rate periods and hence reflect the business models of many institutions.

The explanations above make clear that the proposed uniform regulatory specifications regarding the grouping of NMDs and regarding the assignment of average maturities in principle cannot be sufficiently risk-differentiated. Based on standardised requirements it is not possible to achieve a classification that is correct for each institution.

"Pass-through rates" are not a suitable concept for modelling the interest rate adjustment behaviour and thus for correctly mapping the interest rate risk cash flow.

We find that the restrictive and for the most part inappropriate standardisation of NMDs is disproportionate and not constructive. One of the core arguments put forward for the new regulatory requirements is the prevention of capital arbitrage between banking book and trading book. However, NMDs are by nature contained exclusively in the banking book and cannot be selectively categorised by the institutions.

Behavioural options

We welcome the escape clause in Section II Subsection 2.6 of the consultative document regarding the use of internal approaches for options for retail customers not falling in the NMDs category. At the same time, however, the hurdles for application seem to be too high and would need to be further specified. Moreover, there is no reason why internal approaches should not be allowed also for behavioural options for non-retail customers, provided the institution can prove that the options are not exercised as automatic options.

We believe that the internal models already used by the institutions are in general more suitable than the presented parametrisation in the standardised approach. That approach, moreover, does not take account of hedging effects between customer and interbank options.

Institutions are using a wide range of methods to map both embedded and explicit options (e.g. floors, caps, rights of termination or unscheduled repayment). The specification of a regulatory model does not allow the institutions to use their own methods. In order to reflect appropriately the different business

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models of all institutions, institutions that have set up their own interest rate risk management based on other methods must be allowed to use these methods for the calculation of regulatory requirements.

Moreover, the multipliers applied in the standardised approach do not take account of the particular stability of the retail customer business and, accordingly, are clearly too high. A possible reduction of this effect can in principle be achieved by a smaller starting basis in the case of own estimates. However, often this is not possible due to insufficient historical data, e.g. regarding the pull-through ratio of fixed interest loan commitments.

NII and basis risk

We are critical of the very much simplified and static earnings-based approach (NII approach) designed in the consultative document because it is subject to very strong assumptions.

The proposed NII approach is static and hence fails to have the desired advantage of an earnings-based measure. The approach does not allow for a simulation of the future business developments and hence is inconsistent to the existing institutions' earnings planning, although consistency is explicitly demanded by the EBA in its guidelines on the IRRBB. A further implied assumption of the presented NII approach is that the net positions of all repricing cash flows have to be invested or funded at shocked interest rates until the end of the observation period. This, on the one hand, implies a static continuation of the business with constant margins but, on the other, assumes that e.g. all non-core sight deposits are provided with a new product interest rate, changed by the amount of the parallel shift of the interest curve, after one day. This is in contrast to the actually observed very slow adjustment of sight deposit interest rates and hence the internal management of the institutions, which extend the margins primarily of sight deposits by means of permanently low product interest rates (near zero) at a high market interest rate level.

Basically, there is a theoretical basis risk in an earnings-at-risk approach. The inclusion of this risk is problematic and very general specifications are not constructive. The diversity of the fixed interest rate financial instruments, which usually are used by smaller banks, is low. This applies in particular to institutions that focus almost exclusively on retail banking. Basis risk is negligible compared to the other types of interest rate risk. Due to the lack of materiality (in particular to solvency), calculation of the basis risk is not necessary and from our point of view to be regarded as disproportionate.

Capital adequacy

We do not agree with the Pillar 1 approach in general, i.e. minimum capital charge for interest rate risk in the banking book. Therefore, we do not comment in detail on the options presented.

Rules/guidelines

We welcome the importance that is attached to a Pillar 2 approach. In our opinion, this is the only feasible approach. The presented nine principles for banks support this, especially as the first seven comply with the EBA guidelines. With a few exceptions (see below), we consider the requirements described in the principles to be self-evident. In our opinion, the institutions are already complying with them.

However, we are critical of a mixture of Pillar 1 and 2. Even if Pillar 2 is used, Pillar 1 needs to be calculated completely (as fallback and reference value). This is not appropriate due to the large number

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of shortcomings of the standardised Pillar 1 approach, which we already have illustrated in detail in the context of our comments. In this context, specifications for disclosure according to Pillar 3 should not be provided as well.

We wish to comment on the individual principles as follows:

Principle 1

As described in our "General remarks", credit spread risks are taken into account already in the credit risk, so that the reference to credit spread risks (CSRBB) in Principle 1 should be deleted. This also applies for the other principles in which credit spread risks are included.

Principle 2

It has to be clarified, that the term "Board of Directors" means the Board of Managing Directors as the executive organ in the dualistic management system and not the Supervisory Board.

Principle 5

The requested comparison of one's own assumptions with the standard parameters defined by the supervisory authorities is inappropriate – in particular because institutions have many years of experience with their models and review and assure the validity of their assumptions by means of regular back-testing of the results and sensitivity analyses with respect to the input parameters. In addition, pass-through rates are not suitable for the determination of the core deposits. Pass-through rates are static and, therefore, not disposable. They consider neither the effect of residual term reduction nor that of reinvestment.

Principle 6

This guideline includes the requirement to use a large number of methods to quantify the economic value and the earnings-based interest rate risk. However, the use of two methods – an economic value and an earnings-based method – may already completely suffice. A prerequisite to this is that they are individually tailored to the own bank.

We have the impression that the institutions are asked to use several systems and methods to quantify interest rate risks in the banking book. However, this is not a usual proceeding for the other risk types. With respect to this, we ask for reasonable specifications, also taking into account the proportionality principle.

Principle 7

We ask to delete the words in brackets "(by consolidation level and currency)" because they contradict the previous restriction to "relevant levels of aggregation". We ask to delete the "and" at "and/or" at the last bullet point.

Principle 8

We reject the publication of the results of the fallback solution and the internally used parameters for interest rate risk management. In our opinion, this data is of interest solely to competitors, apart from the supervisory authorities. As this sensitive data is strictly confidential, we oppose the publication of such business-strategy parameters. The paragraph "Public disclosure" should not be extended to detailed information but, at the most, remain at the present level or even be deleted. Likewise, we speak out in favour of deleting the points d, h, i (CSRBB) and k of Table 14 and also the entire Table 15. More detailed specifications of what information is to be published are not necessary. Public disclosure is unacceptable.

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Principle 9

We ask to delete all aspects that relate to the CSRBB. Moreover, the requirement to use internal models in addition to the models prescribed by the supervisory authorities’ results in inappropriate control stimuli. Application of adequate internal models is fully sufficient.

Principle 10 (for supervisors)

We ask to delete all passages concerning the comparison of the internal with the regulatory model.