

**ABI comments on the
BCBS Consultative Document
*Recalibration of shocks for interest
rate risk in the banking book***

March 2024

Preliminary remarks

The Italian Banking Association (ABI) welcomes the opportunity to provide views to the Basel Committee on Banking Supervision (BCBS) about the proposed recalibration of the shocks applied in the context of the interest rate risk in the banking book (IRRBB) framework, as per the consultation paper "Recalibration of shocks for interest rate risk in the banking book".

The regulatory shocks are cornerstones of the IRRBB framework, as they represent the hypothetical changes in interest rates to be assumed in measuring the interest rate risk for regulatory purposes, and notably for the purpose of the supervisory outlier test (SOT). Therefore, the size of the regulatory shocks is a key factor affecting banks' strategies, internal limits, behavioural models' parameters and management actions in the field of ALM and interest rate risk management. For this reason, it is essential that any change in the prescribed shocks is very carefully considered and adopted only if actually needed and strongly supported by evidence (and, in any case, after its impact has been thoroughly assessed).

With specific regard to the ongoing consultation, ABI does not agree with the proposed recalibration, resulting in a sharp increase of the size of the interest rate shocks for certain currencies which seems not fully justified and, in addition, overly penalising for some jurisdictions. The reasoning behind this conclusion is explained below.

Detailed comments

Comments on the proposed recalibration of the prescribed shocks

The proposed recalibration of the shocks is the result of the update of both the time series of the interest rate shocks and the methodology used to determine the size of the regulatory shocks. While the inclusion of updated figures in the time series is deemed appropriate¹, not all the methodological changes proposed seem convincing.

More precisely, as illustrated in the Consultation Paper (CP), the main methodological changes pertain to the following aspects:

- a) shock factors calculated in terms of absolute value changes in interest rates (instead of percentage changes)
- b) use of local shock factors calculated directly for each currency (instead of global shock factors)
- c) move from 99th to 99.9th percentile to determine the severity of the prescribed shock.

¹ More precisely, ABI agrees that, for the purpose of the current update, the most recent observations should simply be added to the sample. For future updates, the possibility of excluding oldest figures should be considered, in order to leave out of the time series elements which are no longer representative of the reality.

As to point a), ABI agrees on considering absolute changes in interest rates rather than percentage changes, as the former are less dependent on the underlying interest rate scenario, while the latter would be no longer appropriate in light of the very peculiar scenario experienced in the last decade.

By the way, using absolute changes seems also more consistent with banks' models measuring interest rate risk, that are normally based on absolute changes. ABI would therefore endorse the adoption of absolute changes as preferred approach for the interest rate shocks.

ABI also agrees on the change under b), as the use of local shock factors instead of global factors leads to more precise results and therefore represents an enhancement of the methodology.

While ABI supports the revision of the observation window and the methodological shift from global to local data and from relative to absolute changes, the change in c) is not deemed as appropriate.

Indeed, according to the CP, the reasons behind the move from 99th to 99.9th percentile lie in the need to maintain sufficient conservatism taking into account "the accommodative methodological changes and the recent rise in interest rates".

In this regard, ABI would argue that the recent rise in interest rates is supposed to be factored in via the expansion of the time series; it is also worth noting that evidence shows that the peak in the interest rate shocks is not necessarily found in most recent observations (eg for EUR the worst shocks are observed in 2008-2009).

The other methodological changes are not per se "accommodative", in that the change under a) is intended to properly capture the magnitude of the changes occurred, where the current methodology would no longer be appropriate, and the change under b) provides for more precise figures.

The mere fact that, as shown in Table 8, for certain currencies the application of the methodological changes - excluding the higher confidence level - would lead to lower calibration cannot be seen as an indicator of lower conservatism. It should rather be read as the reasonable outcome of switching to local shocks (better representing the volatility of each specific currency), from a methodology based on global shocks (with "averaging" effect that could have overestimated the volatility for certain currencies while softening the shocks for others).

The move from 99th to 99.9th percentile seems therefore not justified by a lower conservatism of the methodology nor by insufficient consideration of the recent rise in interest rates.

In any case, the confidence level should be consistent with the aim of the analysis. In this regard, it is worth noting that the standard shocks are used to identify possible outliers in terms of interest rate risk exposure, while a 99.9th percentile confidence level appears more appropriate to determine extreme stress scenarios.

Indeed, as the CP clearly shows, for many currencies – including the EUR – the proposed recalibration of the parallel shocks only stems from the move to the 99.9th percentile, while sticking to the current 99th percentile would leave the prescribed shocks unchanged. The proposed recalibration is therefore not deemed justified.

As said above, a change in the severity of the regulatory shock is likely to determine material impacts, as it would affect banks' strategies, internal limits, behavioural models' parameters and management actions in the field of ALM and interest rate risk management - thus impacting on financial markets, and ultimately deploying effects on features and prices of banks' products.

ABI would also highlight adverse implications such as undue metric volatility (since fluctuations in EVE/NII metrics would occur, despite no increase in the interest rate risk exposure). The shock recalibration might therefore bring to an increase in the number of outliers.

In this regard, the potential negative impact should also be considered, for institutions with internal measurement system, due to the scenario dependency of behavioural models that would need to be recalibrated according to the new scenarios.

All in all, if a change in the confidence level were to be applied in the calibration of the regulatory shocks, the SOT threshold should be recalibrated accordingly.

On top of that, it has to be noted that the proposed recalibration would determine an asymmetric impact among jurisdictions, due to certain areas being severely affected, and others less affected or not affected at all. Among other things, one of the affected areas is the EU, where the consistent application of the current IRRBB framework has proven to be very effective.

With specific regard to the EU, following to the proposed recalibration the parallel shock for EUR would change from the current +/- 200bp to a proposed +/- 250bp.

It is worth noting that our figures for the EUR show that the actual result of the calculation according to the updated approach is extremely close to the mid-range between the +/- 200 and the +/- 250bp, and the proposed recalibration to +/- 250bp is due to the rounding convention adopted. This means that the proposed recalibration for EUR parallel shocks does not actually correspond to the 99.9th percentile but to a much higher confidence level. In other words, the 50bps rounding grid on top of a so high percentile increase risks to lead to scenarios never observed, that would mean losing the real economic sense of the exercise.

This would result in a sharp increase in the size of the EUR shocks (+25%), likely to have a severe impact on EU banks and financial markets, thus making the proposed change overly penalising.

In summary, the proposed shock increase seems not justified by strong empirical support and the effects of the revised shocks appears disproportionate and biased against the EU institutions.

In light of the above, ABI recommends maintaining the confidence level at 99%, thus keeping the overall consistency of the framework still ensuring its conservativeness², and thereby also reducing unwanted effects in terms of metric volatility (and operational efforts by banks).

² It is also worth reminding that other elements of conservatism are already present in the methodology, such as the six-month horizon of the shocks. As the BCBS acknowledges (2015 BCBS Consultative document on IRRBB standards), banks are normally expected to adjust their asset/liability profile in three months, but a six-month horizon is chosen to account for possible longer time needed in case of system-wide move in interest rates.

Comments on the envisaged impact assessment

The CP clarifies that the BCBS intends to collect data from banks to assess the impact of the proposal. While reiterating that the proposed recalibration is not considered appropriate, ABI agrees that, should nonetheless the BCBS consider any change in the shock size, the related impact should be carefully assessed.

In this regard, ABI would put forward some recommendations. In particular, to properly assess the overall impact of the modified shocks, the analysis should consider the full range of application of the shocks and the interplay with possible additional measures applied in each jurisdiction. As regards the EU, an accurate assessment of the impact of the proposed change should take into account at least that:

- in the EU an additional SOT, targeting the change in NII, is envisaged, and EU banks have very little room for manoeuvre to be compliant with both the BCBS SOT on EVE and the EU NII SOT. Due to the very challenging management of the two conflicting SOTs, an increase in the shock size would therefore represent a much stricter constraint (and ultimately would result in a higher number of outliers) for EU banks, than for banks only subject to the BCBS EVE SOT;
- in the EU, the IRRBB framework and notably the SOTs are applied not only at the highest level of consolidation, but also at the individual level of each bank as a legal entity.