Mr. William Coen
Secretary General
Basel Committee on Banking Supervision
Centralbahnplatz 2, Basel
CH-4002
SWITZERLAND

Brussels, 10 September 2015

Dear Mr. Coen,

In June, the Basel committee published its consultative document for Interest Rate Risk in the banking book (IRRBB) and left the occasion to collect comments by September 11. Even though KBC Group largely supports the arguments referred to by the Belgian Banking Federation (Febelfin) as well as the international federations (IIF, EBF), we insist to express our concerns from the perspective of KBC as well. KBC is convinced that the proposal in its current form is not likely to contribute to the overall goal of more stability in the banking system.

KBC agrees that a more harmonized international approach towards IRRBB will allow regulators to execute more uniform peer comparisons. However, KBC deems that the proposal is not fit for usage neither in a pillar 1 context nor through a more standardized pillar 2 approach. The proposal suffers from a number of important inconsistencies that ignore the peculiarities of the banking book. Moreover, the proposal is likely to harm the level playing field between banks and have unintended consequences.

Inconsistencies

The proposed combination of value and earnings based required capital is not consistent with the measurement of the available capital.

Value losses/gains on banking book positions are reflected in available regulatory capital only to a minor extent (i.e. through AFS bonds or derivatives whose MtM passes through P&L). An economic value based capital requirement is therefore subject to a fundamental inconsistency where 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 while 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 consultative document, the Basel Committee touches upon the above criticisms (e.g. p. 31), but decides to avoid the complexity to redefine a value based capital base for IRRBB anyhow.
KBC 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.

In some of the proposed options, capital requirements could also be based on earnings sensitivities linked to alternative interest rate scenarios. Such methodology sheds some light on variability risk, but there is no link to any potential losses. 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. The BCBS attempts to tackle the issue by potentially including an additional buffer linked to historical earnings capacity of the institution. However, KBC deems that the approach remains artificial and ignores the multi year dynamics of banking book management.

While the approach does provide insight to what extent institutions are active in interest rate risk transformation, the absolute value of the proposed capital requirement does not relate in a meaningful way to the available regulatory capital. Even when using the proposed measure as a relative measure for peer comparisons, a more integrated analysis of IRRBB is required to assess the risk profile of an institution.

Level playing field

According to the proposal, cash flows arising from e.g. loans should include the external rate paid by the client. Banks with a strong business model that allows to generate high margins are therefore penalised versus banks that are not able to charge a sufficient stable margin. Put more extreme, banks that lock in a negative margin on the loan business are likely to reduce their required capital as the negative net present value on the loan book will not appear in the capital requirement. Earlier analysis showed that inclusion of the margin within the cash flows could lead to an increase of the reported interest rate sensitivity by 30% or more.

Unintended consequences

Through the predominant focus on economic value as well as the conservative parameterisation of non maturity deposits, the proposal is steering banks to have a shorter investment horizon. But the lower the investment horizon, the faster maturing investments are replaced with new investments yielding a return in line with prevailing rates. In case of interest rate variability, the proposal is therefore likely to introduce increased NII volatility as maturing investments will need to be replaced sooner. We stress that treatment of both transactional and non transactional accounts is extremely conservative with an implicit average maturity of 1.8 years for transactional and 1.5 for non transactional compared to a 5 years and 2 years duration allowed in local Belgian legislation . Note as well that recent EBA guidelines on interest rate risk management also refer to a maximum average duration of 5 years for determining the supervisory standard shock. In addition, internal analysis at KBC supports especially for transactional accounts that the external rate does not follow the prevailing market rates.

In addition, due to exclusion of capital from the liabilities of the EV calculation, <u>well capitalised banks can be expected to have higher capital requirements</u> as higher volume of investments of these capital resources will lead to a higher interest rate sensitivity in the proposed framework.

Way forward?

Provided that (1) parameterisation is aligned with more realistic assumptions, (2) the implicit adverse steering is remedied and (3) the regulator at all times takes into account characteristics of the (local) business model, KBC understands that a proposal for a more uniform measurement will allow regulators more straightforward comparison between different financial institutions (enhanced outlier test). However, given the typicalities of IRRBB, an automated link to a capital requirement is difficult if not impossible to implement in a reliable way. KBC would encourage an approach where capital adequacy is assessed using a more integrated multi year stress testing approach. Through discussion between the institution and the regulator, KBC deems it can learn from the regulator's experience in assessing stress testing adequacy while the regulator will obtain more in depth understanding of the individual bank's situation.

We hope that you find the comments useful and are happy to discuss them further.

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