

Morgan Stanley

September 11, 2015

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

Re: **Interest rate risk in the banking book**

Ladies and Gentlemen:

Morgan Stanley appreciates the opportunity to provide comments to the Basel Committee on Banking Supervision (the “**BCBS**”) in response to its consultative document on interest rate risk in the banking book (“**IRRBB**”) (the “**Proposal**”).

Morgan Stanley provides its products and services to a large and diversified group of clients around the world, including corporations, governments, financial institutions and individuals. Our banking book assets support a wide range of client activities, from retail clients’ home mortgages to lending in connection with transformative corporate transactions.

We support the BCBS’ efforts to strengthen banks’ risk management practices, including through appropriate measures designed to monitor and control IRRBB. We believe that, to be successful, risk management programs should lead banks and supervisors to carefully evaluate, both quantitatively and qualitatively, how each firm will be impacted by system-wide and idiosyncratic shocks across a wide variety of stress scenarios.

We respectfully recommend that the BCBS adopt a Pillar 2 IRRBB approach without the mandatory standardized methodology contemplated by the Proposal. We believe that a Pillar 2 approach would support rigorous oversight and control of banks’ IRRBB more effectively than a formulaic Pillar 1 approach that is inflexibly applied to a diverse range of bank business models. For similar reasons, we recommend that the BCBS recognize national supervisors’ discretion on whether to utilize the IRRBB standardized methodology or to instead rely on supervisory standards tailored to particular business models and markets. While it is critical for banks to manage interest rate risk conservatively and effectively, we believe the Proposal’s prescriptive IRRBB methodology will not produce accurate or well-calibrated capital requirements in all cases, and that the Pillar 2 approach should provide national supervisors with appropriate flexibility.

We support comment letters on the Proposal submitted by The Clearing House Association L.L.C., the Securities Industry and Financial Markets Association, the Financial Services Roundtable and the American Bankers Association (collectively, the “**Associations**”). We submit this comment letter to amplify points of particular concern to Morgan Stanley and our clients.

1. Existing U.S. supervisory standards for IRRBB are rigorous

Managing interest rate risk (“**IRR**”) is a core function for every bank, since interest rates impact cash flows from both revenue-generating assets and funding liabilities. In the United States, banking supervisors have established strong expectations for banks’ interest rate risk management programs. While formal guidance from U.S. supervisors dates back decades, the current guidance is contained in the Inter-Agency Advisory on Interest Rate Risk Management, published in 2010 (the “**U.S. Inter-Agency Advisory**”).¹

The U.S. Inter-Agency Advisory states that “[U.S.] regulators expect all institutions to manage their IRR exposures using processes and systems commensurate with their earnings and capital levels, complexity, business model, risk profile, and scope of operations,” and emphasizes “the importance of effective corporate governance, policies and procedures, risk measuring and monitoring systems, stress testing, and internal controls related to the IRR exposures of institutions.”² The Advisory stresses the important role that bank boards of directors and asset-liability management committees have in managing interest rate risk at specific institutions.³ In addition, the Advisory recommends that banks “use a variety of measurement methods to assess their IRR profile,” and clarifies that, “[r]egardless of the methods used, an institution’s IRR measurement system should be sufficiently robust to capture all material on and off-balance sheet positions and incorporate a stress-testing process to identify and quantify the institution’s IRR exposure and potential problem areas.”⁴ Finally, the Advisory also describes supervisors’ model validation expectations, which include providing the results of IRR model reviews to supervisors.⁵

Consistent with the U.S. Inter-Agency Advisory, banking organizations in the United States are subject today to stringent IRRBB standards, which incorporate quantitative model-based metrics as well as qualitative processes and reviews. The strength of this approach is that it recognizes the complexity inherent in measuring IRRBB across diverse bank business models but focuses on core risk management principles, including interest rate scenario analyses and corporate governance standards, which provide robust and reliable tools for managing these risks.

¹ Board of Governors of the Federal Reserve System, Supervision and Regulation Letter SR 10-1 (January 11, 2010), Attachment: Interagency Advisory on Interest Rate Risk Management, *available at*: <http://www.ffiec.gov/pdf/pr010710.pdf>; *see also* Supervision and Regulation Letter 96-13 (May 23, 1996), *available at*: <http://www.federalreserve.gov/boarddocs/srletters/1996/sr9613.htm>. The U.S. Inter-Agency Advisory is “consistent” with the BCBS’ *Principles for the Management and Supervision of Interest Rate Risk*, *available at*: <http://www.bis.org/publ/bcbs108.pdf>.

² U.S. Inter-Agency Advisory, p. 1.

³ *Id.*, pp. 2-3. The U.S. Inter-Agency Advisory’s corporate governance requirements are generally similar to the standards described in the Proposal’s second principle for banks. *See* Proposal, p. 39.

⁴ U.S. Inter-Agency Advisory, pp. 3, 5.

⁵ *Id.*, pp. 8-9.

We believe that the U.S. Inter-Agency Advisory provides a good model for the development of Pillar 2 IRRBB standards. In other markets, where bank business models are more streamlined but existing IRR risk management practices are less well-established, adoption of a standardized IRRBB methodology by national supervisors may be appropriate. Accordingly, we urge the BCBS to recognize national authorities' discretion, within Pillar 2, to adopt or not adopt a standardized IRRBB methodology.

2. Some elements of the Proposal reinforce strong IRRBB risk management

The BCBS released the Proposal after a nearly decade-long low interest rate period. As banks and markets prepare for potential increases in interest rates, the Proposal provides a strong starting point for revisiting and reconsidering IRRBB risk management practices that may be critical in the coming years.

In particular, we believe that many features of the Proposal will improve IRRBB risk management at institutions, including:

- ***Strong governance framework.*** In all bank business models, risk managers, corporate treasurers, business units and, ultimately, firm management and the board of directors should operate within a coherent governance framework where all material risks are continuously evaluated. We believe that many of the Proposal's principles for banks, which resemble existing supervisory expectations for corporate governance in the United States, provide a solid foundation for developing consistent and robust risk management practices across jurisdictions.
- ***Standardized stress scenario assumptions.*** Standardization of a single IRRBB calculation methodology is necessarily difficult to develop, given the wide range of bank business models. Regardless of their specific business model, product mix or funding sources, however, all banks in a jurisdiction will operate in the same interest rate environment. Accordingly, we support the Proposal's efforts to establish a common set of quantitative IRRBB scenarios. However, we recommend that supervisors be given flexibility to define stable scenarios that do not vary with daily market moves, to facilitate comparisons across reporting periods and to ensure consistency and efficiency of implementation.
- ***Recognition of IRRBB models' utility.*** We support the Proposal's recognition that internal models can play an important role in IRRBB risk management. As a practical matter, even if the BCBS were to adopt a single standardized calculation methodology for capital purposes, banks would still need to develop internal models to effectively manage interest rate risk in their day-to-day operations. As such, we believe that IRRBB standards should incorporate model-based calculations when supervisors have reviewed and approved firms' models, thereby aligning risk management with capital management.

3. Key features of the Proposal’s methodology are unsuitable for a Pillar 1 approach or for a Pillar 2 approach relying on a standardized methodology

As a preliminary matter, we note that the very complexity of the Proposal—which includes four sets of proposals with regard to the calculation of minimum IRRBB capital requirements and 19 IRRBB calculation periods of varying length—underscores the challenge of developing a single, standardized approach for measuring IRRBB that is suitable for banks operating in different markets with varying sizes, products, counterparty profiles, and funding structures. While quantitative analysis is a critical component of effective IRRBB risk management, a single global quantitative methodology for all institutions will not produce reliable measures of IRRBB.

We support the technical comments on the Proposal in the Associations’ comment letters. In particular, we believe that certain technical features of the proposed IRRBB methodology are unsuitable for a Pillar 1 approach or for use in a Pillar 2 approach relying on a standardized methodology, including:

- ***Capital charges for positive earnings.*** A bank may experience earnings declines in certain assets in response to changes in the interest rate environment even while earnings remain positive in those assets. Capital requirements should be based on the risk of actual losses, not a risk of declines in positive earnings; there is no analogous standard in the credit, market or operational risk frameworks in which capital requirements are unmoored from loss risk.
- ***Weaknesses of a single methodology.*** Bank business models vary extensively, both across jurisdictions and across product and client segments within a single jurisdiction. Economic value of equity (“EVE”), net interest income (“NII”) and earnings-at-risk (“EaR”) methodologies have relative strengths and weaknesses when applied to diverse business models. In many cases, a blended methodology incorporating both EVE and NII will produce the most meaningful IRRBB measurements over short- and long-term horizons. The risk management framework should encourage banks and supervisors to apply IRRBB measurement tools tailored and adapted to each institution’s relevant risk profile, rather than adopt a single mandatory methodology that may not be designed for a particular firm’s interest rate risk profile.
- ***Static balance sheet assumptions.*** At its core, IRRBB reflects the risks that a bank will face over time in response to potential interest rate scenarios and client reactions to those scenarios. As such, IRRBB necessarily involves dynamic, forward-looking scenario analyses. The Pillar 1 methodology in the Proposal, however, assumes a static bank balance sheet, which is less realistic than the standards contained in the U.S. Inter-Agency Advisory concerning dynamic balance sheet projections.
- ***Disclosure issues.*** Morgan Stanley is a strong advocate for robust public disclosure standards for banks, which impose market discipline and allow investors and counterparties to effectively evaluate banks’ financial strength. Quantitative disclosures,

however, are only meaningful if they accurately reflect a bank’s risk profile. Accordingly, in light of the numerous methodological concerns with the Proposal, we recommend that, during an initial implementation period, BCBS limit mandatory disclosures of IRRBB results to bank supervisors until disclosure templates are appropriately refined for public use.

In combination, these technical comments raise fundamental concerns with the design of the IRRBB standardized methodology in the Proposal, reinforcing our recommendation that the BCBS should not adopt a single mandatory methodology for application in all jurisdictions.

4. BCBS should not rely on a standardized methodology for identifying “outliers”

We understand that, even if BCBS adopted a Pillar 2 IRRBB framework, supervisors may want to rely on a standardized approach for identifying “outlier” firms and scaling incremental IRRBB capital expectations for such firms under Pillar 2. Just as IRRBB itself is difficult to measure in a standardized manner, however, we also think that identifying IRRBB outliers involves complexity and judgment that defies simple standardization.

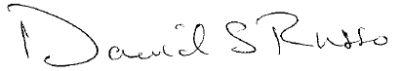
There is a healthy diversity of bank business models, which allows firms to meet the diverse demands of the marketplace and to dynamically manage their businesses in response to emerging risks. A standardized outlier methodology would likely result in the misidentification of actual IRRBB weakness (or strength) in many cases, since banks manage IRRBB in light of their respective product offerings, risk appetites, funding sources, balance of trading book and banking book concentrations, jurisdiction-specific restrictions on banking activities, and other factors that would be difficult to capture in a standardized outlier methodology. In addition, since the Proposal does not include a standardized Pillar 2 outlier methodology, we cannot comment in detail on how such a methodology would operate in practice.

We support a rigorous Pillar 2 approach, which necessarily includes strong supervisory oversight and, where appropriate, heightened capital expectations. The strength of Pillar 2, however, is based on supervisors’ ability to assess banks’ risks within the broader context of supervised institutions’ business strategies, risk management programs, and marketplace conditions. Accordingly, we encourage the BCBS to reject a standardized Pillar 2 outlier methodology.

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Morgan Stanley appreciates the opportunity to provide comments to the BCBS on the Proposal. Please do not hesitate to contact us if you have any questions.

Yours sincerely,

A handwritten signature in black ink that reads "David S. Russo". The signature is written in a cursive, flowing style.

David Russo
Managing Director
Chief Operating Officer, Firm Risk Management

CC: Norah Barger, Board of Governors of the Federal Reserve System
Javed Ahmed, Board of Governors of the Federal Reserve System
Donald Gabbai, Board of Governors of the Federal Reserve System
Charles Taylor, Office of the Comptroller of the Currency
Roger Tufts, Office of the Comptroller of the Currency
Amrit Sekhon, Office of the Comptroller of the Currency
Bob Bean, Federal Deposit Insurance Corporation
Michael Spencer, Federal Deposit Insurance Corporation
John O'Sullivan, Federal Reserve Bank of New York
Ron Cathcart, Federal Reserve Bank of New York
Dianne Dobbeck, Federal Reserve Bank of New York