



August 20, 2015

Mr. Stefan Ingves
Chairman
Basel Committee on Banking Supervision
Basel, Switzerland

Reference: Consultative Document – *Interest Rate Risk in the Banking Book*

Dear Mr. Ingves:

The Mortgage Bankers Association¹ (MBA) appreciates the opportunity to comment on the Basel Committee on Banking Supervision's (Basel Committee) Consultative Document titled *Interest Rate Risk in the Banking Book* (Consultative Document).² The following is a background section for the benefit of MBA's members and others reading this letter and MBA's general comments to the Basel Committee on the Consultative Document.

Background

For banks in the United States, the rollout of Basel III included updates to the definition of capital, updates to the Standardized Approach (including risk weights for various asset categories and off-balance sheet positions), and updates to the Advanced Approach used by the largest banks. Bank's interest rate risk controls and position are assessed by U.S. bank regulators as part of their supervisory review, and there is no separate layer of risk-based capital related specifically to interest rate risk.

The Basel guidelines for bank regulation are built on three important aspects which Basel refers to as the three pillars of bank regulation:

¹ The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mba.org.

² Basel Committee on Bank Supervision, Consultative Document, *Interest Rate Risk in the Banking Book*, June 2015.

Pillar 1 consists of minimum capital requirements.

Pillar 2 is the bank supervisory review process.

Pillar 3 is market discipline. A bank discloses its capital structure and capital adequacy. The market assesses the bank's capital adequacy as part of the process investors use to determine stock prices and the rating and pricing of the bank's debt securities.

Interest rate risk in the banking book (IRRBB) under the current Basel framework is treated as a Pillar 2 regulatory regime under Basel's *Principles for the Management and Supervision of Interest Rate Risk*³ and not a Pillar 1 (risk-based capital) regime. Thus, if a bank is an outlier in terms of interest rate risk measures, the bank's regulator would require corrective action as part of its supervisory review and regulation process.

The Consultative Document proposes to add an additional risk-based capital layer on for IRRBB to "help ensure that banks have appropriate capital to cover potential losses from exposures to changes in interest rates." The consultative document would require a bank to perform certain interest rate shocks and to measure the impact on economic value (EVE) of the bank as well as the bank's net interest margin. It would then prescribe certain regulatory capital requirements based upon the results of those shock scenarios.

Page 15, states, "Under this approach, capital requirements for IRRBB are measured by the scenario that results in the largest decline in EVE." The six scenarios for Pillar 1 include:

- a. Parallel shock up
- b. Parallel shock down
- c. Steepener shock (short rates down, long rates up)
- d. Flatteners shock (short rates up and long rates down)
- e. Short rates shock up
- f. Short rates shock down

The proposed initial scope of the Consultative Document would be to apply the proposed framework to large internationally active banks. However, page 1 of the Consultative Document states that regulators would have national discretion to apply the framework to non-internationally active banks.

³ Basel Committee on Banking Supervision, *Principles for the Management and Supervision of Interest Rate Risk*, July 2004.

General Comments and Questions

Keep IRRBB in Pillar 2

MBA believes that prudential U.S. bank regulators have a robust Pillar 2 framework that includes a detailed quarterly call report, the rating of banks based upon the CAMELS system, a robust on-site supervisory examination process, and a program for prompt corrective action. U.S. bank regulators, likewise require banks of a certain size to conduct periodic stress tests. Further, banks of all sizes in the United States generally have software that facilitates conducting rate shocks, and banks who are SEC registrants generally disclose the results of those shocks in their financial statements or in other sections of their quarterly Form 10 Q and annual Form 10 K.

MBA believes that Pillar 2 remains the appropriate place for IRRBB. Likewise, replacing the existing Pillar 2 regulatory regime in the U.S. with a Pillar 1 regime that is less robust makes no sense. It appears to be an attempt to fix something that is not broken. MBA recommends that the Basel Committee keep IRRBB in Pillar 2.

Proposed Regime for Assets Subject to Prepayment Would Be a Step Backward

Pages 23 through 25 of the Consultative Document describe the Basel Committee's proposed regime for dealing with fixed rate loans with prepayment risk. They describe it as a two-step process. First, the bank determines a baseline prepayment speed, subject to approval by the bank regulator. Then, the baseline estimates are multiplied by supervisory determined scalars for each of the rate shocks.

<u>Scenario</u>	<u>Interest Rate Shock Scenarios</u>	<u>y1 (Scenario Multiplier)</u>
1	Parallel Up	0.7500
2	Parallel Down	2.0000
3	Steeper	0.8500
4	Flattener	1.5000
5	Short Up	0.9000
6	Short Down	1.2000

MBA notes that most European and the Canadian mortgage markets tend to use adjustable rate mortgages in which the concept of behavioral prepayments does not exist. To the extent that longer-term fixed rate mortgages have been tried in those markets,

such mortgages generally include prepayment penalties and lock-outs. In contrast, the predominance in the United States of the 30-yr fixed rate mortgage with no prepayment penalties, lock-out periods, or an exercise option for the full term of the loan required banks in the United States to become more sophisticated in dealing with prepayment risk. Further, the capitalization of mortgage servicing rights (MSRs) as an asset under U.S. generally accepted accounting principles (GAAP) provides banks in the United States with further incentive to accurately estimate prepayment speeds.

As a result, the effort to model prepayments and value MBS began in the 1980s on the trading desks of many Wall Street houses. Starting with static prepayment vectors, the effort quickly evolved to include Monte Carlo simulations including hundreds of interest rate paths and behavioral models which included all available pool-level variables. By early 2000, the market recognized the role of national house price appreciation in generating cash out refinancing opportunities. Then, as the secondary market participants began to increase the variables that they disclose, variables such as loan-size, geography, borrower-credit score and LTV were added as the market began to transition to loan-level models from pool-level models. These models are generally very non-linear, contain interactions between variables, and therefore the application of any bucket-based simplification is quite risky. MBA notes that prepayment models in the United States consider the following factors:

- The refinance incentive inherent (i.e. the spread of the mortgage to current market coupon) in the asset
- Yield curve shape
- Industry capacity
- Origination costs (cost to refinance a loan impacting the consumer's buying or refinancing opportunities)
- Economic factors like unemployment and the housing price index, including the Case – Shiller Index
- Credit scores of the borrower
- The loan-to-value ratio (LTV)
- Geographic location of the underlying property
- Age of the loan
- Available government programs like streamline refi, HARP, etc.
- Mortgage product types (15 year mortgages prepay less frequently than 30 year mortgages.
- Strength of the housing market in general
- ARM/ fixed conversion
- Type of loan documentation
- Occupancy or purpose of the loan
- Origination channel
- Product type
- Incentive to refi to save mortgage insurance

Because of advances in the prepayment software and analytics industries, both behavioral models and the valuation and risk management systems that utilize them have become widely available to banks of all size.

MBA further notes that the Securities Exchange Commission requires publicly traded banks and bank holding companies in the United States to provide the results of adverse rate shock on assets. Stress tests that must be performed under the Dodd-Frank Act need to incorporate in the valuations a number of factors including unemployment rates and interest rate volatility.

Because of these reasons, MBA believes that an approach to assign capital that acknowledges and benefits from the analytical advantages of existing models (while recognizing the appropriate role of external oversight into model validation and the potential use of third-party independent models as a check on internal models) will prove far superior to simplistic approaches utilizing grids, buckets and the pre-characterization of positions into those buckets. MBA therefore recommends that the Basel Commission exclude the approach prescribed on pages 23 through 25 of the Consultative Document and include in the final rule a principles-based approach to dealing with pre-payable assets that would allow reporting banks to utilize available benefits of existing models.

Embedded Gains and Losses

Top of page 31 of the Consultative Document states:

Conceptually, any embedded gains on assets that originated due to a previous fall in rates are a de facto buffer against a subsequent increase in rates. However, to obtain a measure of the net embedded gains (or losses) across all banking book assets and liabilities requires that all the balance sheet (and possibly off-balance sheet) positions that are not fair-valued under the operative accounting framework to be fair-valued both at origination and currently. This requires knowledge of the current term structure of risk-free interest rates and the prevailing term structure when the asset (or liability) was entered into. It also requires the assignment of an appropriate borrower-specific credit spread to each credit risky asset at origination and currently. In addition, a policy determination would need to be made on whether to incorporate changes in the fair value of a bank's own liabilities. Due to the added complexity, the Committee decided not to include offsets for embedded gains and losses in the EVE measure of risk.

Companies in the United States calculate and disclose the fair value of financial instruments that are carried at amortized cost. Likewise, derivative instruments must be reported on the balance sheet at fair value – minimizing the extent of off-balance sheet items. It is not a “heavy lift” for banks in the United States to calculate embedded gains and losses for financial assets and liabilities. The Basel Committee should check with bank regulators in IFRS-reporting countries to see if they do the same. If so, the use of embedded gains and losses would make the EVE more accurate.

MBA Agrees with the Proportionality Concept with Respect to Implementing Any of the Items in the Consultative Document

Pages 37 and 38 of the Consultative Document contain 12 principles. That is followed by a proportionality principle that implementation of the 12 principles should be commensurate with the bank's nature, size, and complexity. MBA agrees with this proportionality in implementing the principles. If prudential regulators in a specific country push the IRRBB regime down to regional and community banks with little, if any, international activity, the infrastructure required to implement and comply should be affordable and proportionate to their size and complexity.

Any questions about the information provided herein should be directed to Jim Gross, Vice President Financial Accounting and Public Policy and Staff Representative to MBA's Financial Management Committee, at jgross@mba.org.

Sincerely,

A handwritten signature in black ink, appearing to read "D.H. Stevens", with a stylized flourish at the end.

David H. Stevens
President and Chief Executive Officer
Mortgage Bankers Association