POLISH BANK ASSOCIATION

Warsaw, 21 March 2024

Basel Committee
on Banking Supervision

Dear Sirs,

Polish Bank Association welcomes the opportunity to put forward our comments on the Basel Committee on Banking Supervision (BCBS) Consultation Document (CD) on the Recalibration of shocks for Interest Rate Risk in the Banking Book (IRRBB).

We would like to indicate some point which can be to some extend specific for our local Polish market but there are important for us because the BCBS standards which should be applied to the international active banks are in the European Union finally applied to all banks. The second reason of our engagement is the big scale of application of floating interest rates in the credit agreement with our clients. This structure is changing but to date the floating interest rate plays dominant role on our local market. This characteristic of market makes the impact of any regulation in this area of interest rate risk in the banking book more sensitive. It is also worth to mention that in our local market the average level of interest rates in higher than in many developed markets using the currency treated as the world currency. We are convinced that the standards of Basel Committee should include the experience of other markets as well and the higher volatility of interest rates in currencies other than the currencies treated as the stable international ones. The Basel Committee should have in mind that the standard should be applicable to other market and currencies which are clearly included in the Consultative Document of the BCBS. This matter is of higher importance in the area of interest rates.

Kruczkowskiego 8, PL 00-380 Warsaw, phone: +48 22 48 68 180, faks +48 22 48 68 100, e-mail: sekretariat@zbp.pl
Nip: 526 000 09 91, PKO Bank Polski SA XV Oddział Centrum 02 1020 1156 0000 7202 0008 6215

- ***Impact on Supervisory Outlier Test (SOT)***

The role of the suggested shocks is to be used for the calculation of Supervisory Outlier Test (SOT) on Economic Value of Equity (EVE) and Net Interest Income (NII). It appears quite surprising that the Consultant Document is fully silent on what the shocks apply to and how a change in percentile might have on banks' business models and management of interest rate risk in the banking book.

The *SOT EVE* is part of the 2016 *BCBS Standard on IRRBB Management* with a hard coded threshold defined as 15% of Tier One. The *SOT NII* is left to the discretion of each jurisdiction. In Europe, the *SOT NII* is to enter into force by mid-2024 with a hard coded 5% of Tier One threshold. SOT NII has been set by EBA at 5% Tier1, which is significantly lower (more restrictive) than the 15% Tier1 set by Basel for SOT EVE and additional SOT-type measures. As a result, most of the Polish sector exceeds SOT NII, i.e. most of the sector is an outlier, which contradicts the definition of an outlier. Therefore it is worth to clarify what the additional SOTs are for, that their more conservative levels may lead to other risks (be counterproductive vs. the purpose of risk reduction) and their levels should indicate outliers according to the definition and not that entire banking sectors are outliers.

When subject to *SOTs*, banks have to factor them in their IRRBB management framework which usually leads to adopt even stricter internal thresholds either self-imposed by banks or under the supervisory pressure.

As the thresholds applicable to *SOTs* are locked in binding regulation, there should not be methodological change on the calculation of *SOTs*, notably on the supervisory interest rate shocks to apply.

The role of *SOTs* is to identify potential outlier interest rate exposures. The 15% (and 5%) thresholds have been calibrated to correspond to a small portion of considered banks based on currently applicable supervisory shocks. Increasing the supervisory shocks would mechanically increase the number of banks identified as outlier hence deviating from the threshold calibration method. This would most probably lead to changes in actual IRRBB management, notably to avoid supervisory measures derived from being identified as outlier, without necessarily economic substance in those changes.

The recalibration of shock scenarios in the scope proposed in the consultation document should be accompanied by a recalibration of the adopted threshold in relation to ΔEVE (15% Tier 1) defined in the BCBS Standards regarding IRRBB of April 2016 - due to the fact that the 15% level in question has been calibrated using previous interest rate scenarios. The lack of such recalibration would make it impossible for many banks to meet it - with much higher assumed shock changes in interest rates in many jurisdictions, additional restrictions on interest rates on deposit or loan products are triggered, even at relatively high interest rates - in the absence of a developed market for instruments hedging instruments with a non-linear payout profile in many currencies, this could force (within certain ranges of interest rate levels) excessive hedging activities (also using the so-called natural, balance-sheet hedging), which could lead to negative financial consequences for the institution in the event of multi-directional movements in rates percentages.

Hence, careful considerations should be paid to the ramifications of any change to supervisory shocks that would need to go together with recalibration of applicable thresholds. Though Quantitative Impact Studies (QIS) would support such an analysis, there would be a need to adopt through the cycle *QIS*, accompanied with qualitative impact studies to support the quantitative-only impact studies.

We could imagine, the envisaged increase of +25% in the magnitude of supervisory shocks would basically make the SOTs 25% more binding but this is not true. In many jurisdictions, the higher shock is applied, the more constraints appear – e.g. zero rate floor on retail depos, maximum rate on credit products (that causes multiplier effect) etc. That's why such an increase in magnitude of shocks results in much higher tightening of the SOT limits (even with relatively high interest rates environment – especially in the absence of a developed market of hedging instruments with a non-linear payout profile in many currencies[1]) – that's why the QISs are very important. Hence for sure such a change should not be considered as a 'technical' change.

It is worth reminding that not all jurisdictions have implemented the BCBS SOT. The changes in supervisory shocks would magnify the uneven playing field and penalize banks from jurisdictions having implemented SOTs such as European banks.

[1] This could force (within specific interest rate ranges) excessive hedging activities (also using the so-called balance hedging), which could cause negative financial outcomes for the institutions in the event of interest rate changes in different directions.

- ***Absolute Shocks vs. Relative Shocks***

  As rates have been normalizing after a long period of extremely low or even negative rate environment, the relative shock approach that BCBS used to apply fails and would lead to non-sensical shocks. It makes sense to adopt an absolute shock methodology.

  However, this change should not be presented as an accommodation as non-sensical relative shocks would be excessively high compared to economically sound absolute shocks. There is no economic substance in presenting the adoption of absolute shock as an accommodation.

  As a consequence, the proposal to substitute a 99.9% confidence interval to the 99% confidence interval to offset the accommodative change is simply not founded.

- ***Methodology Change from 99% to 99.9% Confidence Interval***

  The Consultative Document does not provide any empirical justification of substitution of the assertion. Maintaining the 99% confidence level would result in decreased shocks for various currencies.

  Beyond not being substantiated to offset an 'accommodation', the change from 99% to 99.9% confidence interval has several fatal flaws.

  First, as described above, it would be a fundamental deviation from the calibration that was used to set in stone the *SOT* thresholds: it would be inconsistent to change the methodology of supervisory shocks without changing the SOT thresholds. In Europe where *SOTs* are binding, such a ~+25% increase in supervisory shocks should be accompanied with a proper (substantially higher) increase in applicable thresholds, i.e. >>18.75% for *SOT EVE* (vs. 15%) and >>6.25% for *SOT NII* (vs. 5%). To make a parallel with Risk Weight Assets (RWAs) and capital requirement, the proposal would be similar to mechanically increase RWAs by +25% while not changing the capital requirement: no such a change would be presented as simply a technical change.

  Second, the change makes the methodology extremely sensitive to only a very few points, i.e., 6 historical data points. This is simply not statistically valid and makes the proposal mathematically flawed. The more relevant 99% confidence interval identifies 46 historical data points that is more statistically founded.

In the EU the implemented SOTs on EVE and NII are based on the BCBS interest rate shock scenarios. For each SOT, a threshold applies, which may lead to supervisory actions, though not automatic, when crossed. The envisaged increase in confidence interval would result in higher shocks for currencies, and therefore to materially higher SOT results for European banks without any increase in actual interest rate risk exposure. This would mechanically increase the number of outliers. To avoid being an outlier banks' would have to adjust strategies, risk appetite, internal limits, banks profitability and ultimately deploying effects on features and prices of banks' products. As this could lead to unintended consequences for the banking industry and even the way banking products being offered, this would need to be carefully considered.

- ***Historical Data taken in Consideration***

The level of interest rates, their volatility change over time. In our opinion basing the supervisory shocks on an observation period from 10-20 years ago while ignoring the most recent period would not be appropriate. The extension of the observation period to include the years 2016-2022 is therefore deemed appropriate considering the prolonged low interest rate environment occurred after the Global Financial Crisis. We have recently experienced completely different period when high inflation has provoked many central banks to change monetary policy tools and to raise official interest rates. In this environment the interest shocks look completely differently. We understand it is the last experience but it is so specific that it should be included in the mechanism of interest rate shocks.

This matter provokes us to conclusion that the BCBS should consider incorporating a rolling observation window which would be long enough to cover different points in economic cycles.

- ***Applicable Rounding***

On a technical ground, the 50 bps rounding appears too large and would benefit from being substituted with a 25 bps rounding to avoid detrimental cliff effect.

For instance, a historical shock of 228 bps would be rounded at 250 bps instead of 200 bps if the historical shocks were just 3 basis points lower e.g., 224 bps (the 228 bps occurs when considering the parallel shock in EUR at 99.9% confidence interval).

- ***Horizon***

  The shock methodology is based on six months horizon while it is assumed to be applied immediately in the *SOT EVE*, which is conservative. On average the shocks with a three-months holding period would be 50/100 bps lower compared to six-month holding period.

  A 6-month horizon implicitly assumes that the bank does not mitigate its IRRBB exposure for six months, which is not consistent with actual management.

In our opinion it is worth considering the use of shocks spread over time (NII). The current proposal assumes the use of immediate shocks (even though their calibration includes long time windows). The situation of immediate changes in shocks on such a scale is not reflected in reality.

- ***Application of shock parameters***

As we have expressed in our position at the beginning of our comments we would like to include in the proposal of BCBS standard also the specific situation of additional local markets where the level of interest rate applied is usually higher than on the market in the most important currencies. This is the reason why we are strongly in favour of adding some additional currencies. We do not see any reason why such currencies as the PLN should be not added. We see at the list the currencies where the scale of business activity is much more limited in comparison to the volume of transactions concluded in the PLN.

We hope our comments will be useful for the final preparation of amended standards in area of managing the interest rate risk in the banking book.

Yours sincerely,

Dr Tadeusz Białek

President

Polish Bank Association