



POLISH BANK ASSOCIATION

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Basel Committee

on Banking Supervision

Polish Bank Association response to the BCBS Consultative Document on "Interest rate risk in the banking book"

Dear Sirs,

General comments

The PBA welcomes the opportunity to comment the BIS proposal of new capital regulatory treatment of interest rate risk in banks. The analyzed Consultative Documents creates new regulatory approach to the banking prudential regulations in this area. In this regard we have two principal comments.

Firstly, the idea of new approach is to be dedicated mainly to big international banks which are able to manage the complicated system of calculation presented in the BIS proposal. However, it is mentioned that national regulators might elect to apply this framework at different level of consolidation, including on entity bank. As we know from the latest history, the local regulators, particularly European authorities, use the BIS standards very often as the good opportunity to apply the same prudential requirements as mandatory solution for all banks active on the local market. In our opinion Basel Committee on Banking Supervision should have in mind this practice and analyze the impact of its proposal on activity of smaller banks, particularly active in the limited scale. For many such banks it will be difficult and very expensive task to fulfill proposed requirements. We

underline this point because the BCBS proposal does not contain the possible alternative solution for smaller, less sophisticated banks. In our opinion BCBS should deliver simpler solution for unsophisticated entities.

Secondly, from opposite point of view, we assess that the proposed approach covers important elements of interest rate risk but seems too simplistic. Specifically the defined methods of measuring the capital do not allow to properly cover the differences in risk profile between the banks and countries and would strongly distort their risk management processes. In many cases they can even miss the material risk generated in the bank (consider for example a savings bank with a big portfolio of core NMD invested in 1 year sovereign bonds – for it capping core NMD will reduce the capital instead of increasing it as without the cap duration of NMD would probably be bigger and EVE sensitivity higher).

Below we present the detailed comments to the text of Consultative Document.

1. In Section I.2 (on page 5) we understand there is the conclusion going from present experience that notional balances should be slotted into maturity buckets of no longer than 5 years. However, in section II.2.5 (on page 22) there is the longest tenor included as 6 year period. In our opinion this difference in maturity buckets should be explained.
2. There is assumption, especially in parallel shifts in interest rate curves, that interest rates after shift should be not negative. At present the interest rates in several currencies are negative (e.g. CHF, EUR, SEK), so this assumption should be adequately changed. In case of negative interest rates in scenario assuming downward shift of interest rates and assumption that interest rates should be not negative after shift causes, that on several tenors interest rates should be shifted upwards. Moreover, the proposed calibration of scenarios can lead to unrealistic assumptions for countries/markets which have medium level of interest rates (5%-7%). For example possibility of short term interest rates falling from 6% to 1%, in the six months horizon, is allowed, which looks very aggressive and not very realistic (85% alpha for short term rates).
3. On page 7 concerning the definition of basis risk we would like to express our opinion that this risk is too wide – tenor basis risk and currency basis risk are addressed very well in other risk measures like VaR or Expected Shortfall. Tenor basis risk is moreover included in gap risk, so there would be double counting for the same type of risk. Currency basis risk can be addressed by analyzing gap risk in different currencies, so in order to reduce calculations basis risk should be the only risk of rates in similar tenors but priced using different rates.

There should also be added that some kinds of instruments are exposed to that kind of risk. It refers especially to floating rate notes, where coupons are fixed at basis of different interest rate curve than interest rate curve used to discount cash flows.

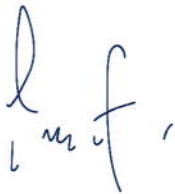
4. On page 7 concerning the optionality risk we would like to ask for reference, how to include demographics, social factors and other similar factors into behavioral option.
5. With the proposed setting of scenarios on page 15, where shocks are defined relative to the current level of rates, the capital for interest rate risk would change strongly depending on the phase of interest rate cycle. In medium/high rates environment the shocks would approach 500 bps whereas for low rates 100 bps. Keeping the constant balance sheet structure it would translate into proportional changes in the capital (for example 2x times increase when rates go 2x up). Such behavior of capital seems unjustified.
6. In the TIA method the Consultative Document imposes on average 50% cap for core deposits (for example only 60% of retail zero remunerated NMD would be considered core even for markets where rates are still strongly positive) which can very poorly reflect the characteristic of some banks with sizeable portfolios of zero remunerated products. The adoption of such parameters which are partially inconsistent with banks' experience can lead to the distortion of interest rate risk hedging strategies which are applied by banks and increase the risk instead of mitigating it.
7. Time Series Approach (TIA) method for NMD requires 10 years of data time series in a specific predefined breakdown. Such a set of data can be however unavailable for some banks. In addition, neither the time horizon is not specified (1 month, 6 month, year?) for which assessment of deposits stability should be calculated nor the required confidence level for the calculation.
8. On page 21, there is table 4 which indicates stability caps and pass-through floor for NMDs by category. The banks ask the question if in the case of sound calculations when results of stability exceed numbers given in the table banks may use own calculations. We would like to mention that these caps may deviate across countries, so could you give analyses, which prove these numbers.
9. The behavioral model can not be standardized with a fixed set of the same quantitative parameters. In fact the risk depends on products, consumers' behavior, market competition, regulatory environment. The application of the same approach for all may lead to a

misleading perception of comparability but in fact it can miscalculate the risk generated in every bank. As the consequence the level of required capital will be inappropriate.

10. The level of basis risk for administered rates can be influenced by changes in the law. Such changes can affect the relationship between administered and market rates and distort historically observed relationships which is not tackled by the proposed approach. In addition, it is not clear how to assign a reference rate for example to the fixed-rate term deposits when assessing basis risk.

All above indicated comments take us to the general conclusion that the regulator should analyze once again all arguments in favor of implementation of new prudential requirements in area of interest rate risk in banking book in Pillar I. In our opinion, presented after internal consultation with the Polish banking sector, we are of the opinion that interest rate risk in banking book should be covered under Pillar II.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'K. Pietraszkiewicz', with a stylized flourish at the end.

Krzysztof Pietraszkiewicz

President