

Consultative document on Interest rate Risk in Banking Book

Punjab National Bank (PNB) thanks the Basel Committee on Banking Supervision (BCBS) for seeking inputs on the Consultative document on the Interest rate risk in the Banking Book. The document seeks to amend the IRRBB framework through following two options:

- 1) A standardised Pillar 1 (Minimum Capital Requirements) approach
- 2) An enhanced Pillar 2 approach (which also includes elements of Pillar 3 – Market Discipline).

Banks are in the business of taking risks and getting rewards. No Banking business is without risk. Though, a minimum capital is definitely required as a cushion against failures but, capital is not the remedy against all risks. Therefore, strengthening of systems and procedures is also of utmost importance.

BCBS has commented that the securities in banking book and trading book, though exposed to similar risks are treated differently. This treatment is due to difference in perspective and holding period of the securities i.e. long term in the banking book and short term in Trading Book. In Indian context, the regulatory requirement of maintaining Statutory Liquidity Ratio (SLR) also plays a critical role in the assumption of interest rate risk at both banking book as well as trading book level. The major portion of investments in the banking book of Indian banks is SLR which is usually held till maturity.

Further, the shuffling of investment portfolio between banking book and trading book is allowed by the regulator once in a year only at market price or book value whichever is lower, which automatically restricts the option of earning incentive on account of capital arbitrage.

EVE approach may not be a big concern for the bankers keeping in view the holding period of banking book and term structure of assets and liabilities, whereas on the other hand, NII approach may be of immediate concern as it will impact the profitability in short term. Therefore, Capital for EVE approach, subject to certain threshold criteria (such as decline in EV, resulting from an interest rate shock, is greater than 20% of Tier I and Tier II Capital) should be suggested by local supervisor as was previously advised by BCBS. Though as of now, no Indian bank has crossed the threshold, the proposed change in the regulatory capital requirement in IRRBB will be treated as an Introduction of Capital Requirement for IRRBB. As such, we are of the view that such an apportionment of capital to cover the potential losses should rather be addressed through a stringent and enhanced Pillar II approach by introducing certain outlier limits.

Similarly, for impact on NII, a particular threshold limit be advised over which certain capital may be prescribed under Pillar 2 approach.

As enumerated in the document, a trade-off between EVE and NII is required. To ascertain this trade-off, we suggest that an impact of 50 bps on NII and 200 bps on EVE is an ideal ratio.

- **The Committee is seeking comments on technical aspects, particularly regarding the approaches for behavioral options, the earnings overlay and basis risk.**

The classification criteria for categorization of NMDs into Retail/Transactional, Retail/Non-transactional and Wholesale deposits is subject to wide variation on the global platform because of the difference in the demographics, economic stratification and other local conditions. As such, we suggest that the categorization of NMDs should be left to the discretion of the national regulator.

We also do not subscribe to the view that the non-core portion will be due for re-pricing in the overnight bucket. Such a big quantum of deposits will not be re-priced instantaneously rather it will be re-priced in different time buckets. It may affect the current structure but certainly not the overnight bucket only.

- **The Committee is seeking comments on specification and values of the standardised risk parameters (eg pass-through rate, stability rate, maturity cap, conditional prepayment rate, pull-through rate, term deposit redemption rate, time horizon of the earnings measure, basis risk parameters) as well as constraints on the own estimate risk parameters (eg stability cap, pass-through floor, maturity cap).**

The stability caps assigned in the document are on a lower side as compared to the current behavioral position which in turn worsens the situation by the application of pass through floors on the same. In addition, the placement of non-core deposits is leading to an exorbitant outflow in the overnight bucket, which is an exceptional scenario considering the Indian context. As such, we are of the view that estimation of stability caps and pass through rates should be left to the discretion of the national regulator.

In addition, it is suggested that methodology for estimation of base CPR, TDRR and PTR be specified. In case of increasing interest rate regime, the prepayment of fixed interest rate loans is indifferent to the movement of interest rates and the scalar multipliers assigned are not able to substantiate the outcome accurately.

Further, the scalar multipliers for conditional prepayment rate treat retail and corporate loans in the same manner where as on the contrary, its quantum should differ for different loan portfolios.

- **The Committee is seeking comments on specification, selection and calibration of the prescribed interest rate shock scenarios.**

The Committee is proposing a six-month holding period for the interest rate shock calibration to be suitable for IRRBB capital purposes which we consider should be left to the discretion of the national regulator as most of the Indian banks are computing the impact on NII on monthly basis and on EVE on quarterly basis.

Further, the impact on NII is calibrated for a change of 50 bps in the market interest rates whereas for EVE the impact is measured for a change of 200 bps in market rates of interest. Keeping this view, it is suggested that the floor of 50 bps is applied to all local interest rate changes as a result of the interest rate shock scenarios and a cap of 400 bps for short term and parallel shock for stress test.

The Committee also proposed to develop a process including a methodology for updating the interest rate shock scenario selection and interest rate shock scenario calibration which we suggest to be based on the Recency and Frequency analysis of the interest rate movements in the global scenario which further incorporates the effect of the local conditions.

Also, the application of scenario specific CPR, PTR and TDRR over the different time buckets needs further clarification. As in case of Short up Interest rate scenario, the scenario specific CPR, PTR and TDRR application to all the time buckets or only to the short term buckets is still murky. Even, elucidation of the application of the medium and long term scalar multipliers for the interest rate shock scenarios is required.

- **The Committee is seeking comments on specification of the candidate minimum capital requirements calculations, in particular on a possible earnings-based overlay to the EVE measure, the scenario-consistency principle and currency aggregation rule.**

The fundamental objective behind regulatory capital/capital adequacy requirements is to ensure the protection of the banks, their customers, the government (which is liable for the cost of deposit insurance in the event of a bank failure) and the economy, by establishing rules to make sure that these institutions hold enough capital to ensure continuation of a safe and efficient market and able to withstand any foreseeable problems.

The Minimum capital requirement is defined only on the basis of the known/actual risk to the bank. It cannot be assigned on the basis of the hypothetical scenarios which have no resemblance with the actual situation. Such scenarios reflect the uncertainty risk and have very low probability of occurrence in future. Capital of a bank is a not a recourse for the various risks that a bank faces. It is ideally used when the bank is winding up and is on the path of liquidation. As such, it is suggested that the IRRBB should remain a part of Basel Capital framework's Pillar 2 Approach (Supervisory Review process) as is being done.

Further, Capital requirement for EVE and NII approach may be subject to certain threshold limit which is to be advised by local supervisor on the basis of global standards, aligned with the local conditions. At present, Indian banks have already been advised by the national regulator for providing capital, if the impact on EVE is more than the threshold level of 20% of capital funds on an interest rate shock of 200 bps. Till this threshold no capital is required to be maintained.

- **The Committee is seeking comments on the mandatory disclosure of the standardized framework under the Pillar 2 alternative.**

The Pillar II approach envisages that IRRBB (including CSRBB) being an important risk for all banks that should be specifically identified, measured, monitored and controlled. We are of the view that CSRBB, which is individually addressed under Credit risk under Pillar I and Pillar II approach, should be kept outside the purview of IRRBB. As otherwise, it will lead to redundant apportionment of capital for CSRBB. However, in Indian context, the credit risk spread is high for the risky borrowers but due to market forces and competition, the same has to be reduced, as otherwise, a

higher price will either make the projects unviable or pushes them towards non-performing assets.

- **The Committee is seeking comments on information as to how the standardized framework measure compares to banks' internal interest rate risk in the banking book measures.**

The committee has suggested the adoption of either the standardized approach or the internal estimates approach for the positions with behavioral options. The adoption of one of the approach is primarily characterized by the asset liability mix which will specify the relevance and importance of a particular approach. This phenomenon is to be seen for the entire industry rather than an individual bank.

As in Indian context, the fixed rate loan commitments are negligible as maximum advances are now floating and linked to the base rate, the ratios like pull through ratio, lapse ratio lose their relevance. Further, in the initial stages of application of such behavioral options, it is considered ideal to have a view defined by the national regulator to lead the entire industry. Therefore, we are of the view that, standardized approach would be ideal to start-off with, and a gradual movement to the internal estimates approach will emanate better results.