

AEB's response to:**BCBS CD on Interest Rate Risk in the Banking Book (IRRBB),
September 2015**

From the Spanish Banking Association (AEB¹), we appreciate the opportunity to respond to the BCBS Consultative Document (CD) on Interest Rate Risk in the Banking Book (IRRBB) issued on the 8th June. We fully support the comments of the IIF, AFME and EBF/IBFed in which responses this Association has participated.

However, in this response we would like to emphasize certain aspects that are especially relevant to the Spanish industry and make some additional comments on the BCBS proposals on IRRBB.

We support the BCBS's efforts to enhance the regulatory framework capturing interest rate risk in the banking book, however:

- We believe that due to the heterogeneity in the nature of IRRBB across jurisdictions caused by customer's behaviour and product characteristics, a tailored approach will be necessary at both jurisdictional and entity level to ensure that capital requirements are reflective of risk levels.
- A standardised Pillar 1 approach fails to take into account these significant differences in balance sheet structure and market practice across different jurisdictions and may introduce systemic risks. We believe that there is not a "one size fits all" approach for IRRBB.
- Any capital requirement for IRRBB should consider potential loss of capital, not variability risk. The CD is primarily focused on variability risk, not loss risk and it would effectively capitalize opportunity costs, rather than actual losses.

Due to the reasons outlined above, we consider that the capital treatment for IRRBB should remain in Pillar 2 and that the ICAAP and the SREP processes under the Pillar 2 framework are best equipped for banks and regulators to appropriately assess any capital requirements for IRRBB. The Pillar 2 framework allows bank's own assessment of IRRBB using internal models aligned with the bank's business as usual risk management practices.

Concerns on "one-size fits all" approach to IRRBB

As an industry with a retail business model and a global footprint, Spanish banks operate across countries with very different economic environments. This diversified business model requires an in-depth knowledge and an understanding of jurisdiction specific characteristics (including product types and customer's behaviour in response to interest rate moves) in order to appropriately assess the IRRBB risk exposure in our banks. We are concerned that the proposed highly standardized approach to capital requirements for IRRBB, with constrained representation of certain aspects of risk exposure, could have adverse

¹ The Spanish Banking Association (AEB in its acronym) is the voice of the Spanish banking sector representing and defending the collective interests of banks operating in Spain (88 member banks: 55 Spanish and 33 credit entities' branches of foreign banks operating in Spain), with total consolidated assets of € 2,402 billion as of December 2014 and 101,962 employees in Spain.

consequences – in particular that risk levels are likely to be misrepresented and inappropriate actions incentivised.

We appreciate that there is an aspiration to adopt a globally harmonized approach to IRRBB capital requirements. However, an overly standardized approach will not be able to appropriately reflect risk exposures and we fear that such an approach will not provide a true sense of harmonisation.

An overly standardized and prescriptive approach to capital requirements will not be able to reflect the behavioural features regarding the banking book exposure to interest rate risk and capital requirements will consequently not be representative of the risk levels. In contrast to trading book transactions, the majority of banking book transactions are affected by behavioural components and, as a result, assumptions are required to determine factors such as the maturity date and price sensitivity. Hence, divergence might occur between the regulatory capital treatment and the economic view of risks, and also between banks' risk management practices that are considered appropriate to tackle real interest rate risk and those oriented to diminish the level of capital requirements. Under such a situation, drivers of capital requirements will potentially be opaque and generate significant confusion to senior management.

Regulatory Concerns – Loss risk vs Variability risk

We understand that one of the main concerns of the regulators as outlined in the CD are the potential losses to banks caused by changes to the prevailing level of interest rates, especially in the current low rate environment. However the CD is primarily focused on variability risk and not loss risk.

It is important to highlight key differences between profit and loss recognition in the trading book and the banking book. In contrast to the treatment in the trading book, where any change or variability mark to market will immediately feed through to profit and loss, in the banking book, income is typically accrued over time. Besides, variability of the income, if still positive, will not cause a loss but rather an opportunity cost.

A capital charge for IRRBB should accurately reflect the levels of risk exposure for the bank, indeed both regulators and banks should be concerned about any losses which would cause threats to banks solvency. Thus, capital should be required only when changes in NII cause earnings to go below zero or changes in EVE cause EVE to drop below its book value. We believe that IRRBB risk measurement, reflecting effectively opportunity costs, is conceptually very different from current Pillar 1 risk types, and therefore should not be treated as an additional Pillar 1 risk type.

Risk of unintended consequences from a highly standardized framework

We believe that any standardization for IRRBB capital requirements should be mainly focused on areas such as stress scenario designing and calibration, governance framework and reporting templates. Nonetheless, assumptions for IRRBB capital requirement assessment should not be standardized or significantly constrained; restrictions on the behavioural assumptions and their treatment will likely lead to unintended consequences. For example, distorting IRRBB metrics and encouraging management strategies that are not aligned with real risks. In particular, an overly prescriptive standardised approach to Non Maturing Deposits does not allow to cater appropriately the diversity of products, markets and idiosyncratic features that banks with global presence capture in their internal models.

It is our concern that the proposed approach would lead to less diversification among banks business models due to potential adverse capital requirements impacts. Banks will review their product offerings in view of the capital requirements from the proposals and some products are likely going to become economically unviable, particularly long dated credit (both fixed and variable rate) and high margin products as banks are discouraged to hold longer dated assets as part of structural hedging programmes.

As a consequence end-users will likely be impacted as banks will have a further barrier to undertaking their maturity transformation and risk management functions protecting customers from changes in the level of interest rates. Instead, interest rate risk will likely be transferred back to customers. Shadow banking entities may also increasingly become suppliers of the products that banks are disadvantaged through these capital requirements from providing, even though such products economically (and in reality) are of low risk to the banks.

Shock scenario design causing procyclicality of capital requirements

The proposed design of the stress scenarios will increase procyclicality of capital requirements and hence the instability of capital metrics. Basel outlines that the rate shock should reflect a *"stressful rate environment"*. However, the stress scenario design means that the higher the level on interest rates, the higher the shock and consequently the higher the capital requirement, although as outlined in the consultative document caps and floors do apply to the size of the shocks.

Further, the CD stress scenarios are calibrated to a six month holding period which in our opinion is very long, if we assume that the holding period should correspond to the longest period needed for an orderly hedge the portfolio.

The main weakness of the proposed methodology is that it does not take into account local volatility but the mixing-up of all different current curves in different currencies to arrive at a set of standardized global shock parameters. As a result, the scenarios do not reflect the relative levels of volatility in the different currencies and this leads to divergence to internal risk management practices and distorts the outcome. The CD does mention that local volatility shock parameters have been discussed by the BCBS but was dismissed due to possible shortcomings of using historical data to predict future volatility and the practical difficulties to maintain local volatility factors in the global standard. As a result the approach will over or understate the interest rate shock where the local volatility is relatively lower or higher than the average global volatility.

The specification of the shock scenarios as proportional to the current level of interest rates means that the capital measure will inherit fixed income markets volatility, leading a potentially very unstable metric. Furthermore, the way the stress scenarios are combined in the proposed capital measures will be in general inconsistent with the underlying correlation structure, both between currencies, and among tenors for a given currency. As a consequence the capital metrics will be unstable, since they depends on the level of interest market rates (through the scenarios), and not only on balance sheets structures.

An alternative method would be that the national supervisors prescribe the stress scenarios for their local currencies.

Currency aggregation approach misrepresents real risk

The proposed currency aggregation approach is inconsistent with the scenario design and the methodology only allows limited recognition of diversification benefits across currencies:

- The scenario design applies the same type of shocks to all currencies independently and then, results are directly combined by type of scenario (ignoring the rest of all possible combinations). This implicitly assumes perfect correlation and does not reflect the existing correlations between currencies.
- The proposed metric is asymmetrical, assumes perfect correlation between losses but just a little correlation between losses and gains.

We think that this proposal could jeopardise the level playing field and disincentive financial institutions to diversify their risk. The proposal has not been supported by empirical evidence and penalizes banks like the Spanish ones, with global footprint and with significant diversified portfolios across currencies. In fact, the approach means that the proposed regulatory metric will overestimate the capital requirements for IRRBB on aggregate terms. In contrast, this will be a minor issue for those financial entities whose main exposure is limited to 1 or 2 currencies. For example, capital required would be exactly the same for a bank with a exposure concentrated in only one currency than for a bank with the same exposure but distributed across several currencies (all with the same net sensitivity) while the fact is that its level of risk is lower.

Furthermore, the methodology defined in CD may tend to give diversification benefits to certain types of balance sheet structures, while denying it to others that nonetheless may bear a similar or lower amount of risk. For example, it will be advantageous for banks to alternate net asset and net liabilities positions (i.e. negative and positive sensitivities) among the different currencies in order to lower their regulatory capital charge. However, the measure will fail to capture the risk associated with those balance sheet structures, where the worst loss is suffered when rates rise in one currency but decrease in the other. In fact, that would be expected to happen in case of negative correlation.

Therefore, we suggest that the current treatment for dealing with exposures in different currencies should be reviewed.

Treatment of equity, additional Tier 1 and Tier 2

Banks typically manage IRRBB on a 'going concern' basis but we notice that the proposals seem to take a 'gone concern' approach to IRRBB by excluding equity as well as additional Tier 1 and Tier 2 capital. The modelling of additional Tier 1 and Tier 2 as having no duration does not reflect the actual repricing feature of these instruments in each interest rate scenario. Besides, it is not unusual that banks hedge these issuances, therefore excluding them will result in a fictitious mismatching hedge position.

The capital framework needs to allow for appropriate reflection of risk mitigation activity undertaken by the bank. The use of such prudent risk management techniques should fundamentally be encouraged – and not penalized – by the capital framework.

We believe that it should be a Board decision of the individual firm to decide whether to apply duration to equity or not, explicitly or implicitly, for the purposes of its structural hedging programme. Regardless of the assumption applied, as part of the banks governance framework, there should be a robust set of documentation of the rationale for the chosen

equity treatment. This should address the regulatory concern of potential capital arbitrage as the result of unjustified changes of assumptions.

Concluding remarks

Considering the potential significant impact that the CD proposal might cause on the banking industry management practices, it would be advisable to review the current approach thoroughly in order to reflect accurately the risk exposure on IRRBB. Eventually with a broader timeframe for the discussion and better knowledge due to the complexity of a fundamental revision, as it has been recognized by BCBS several times in the previous revision of the topic.

The approach would need to be flexible enough to ensure that jurisdictional and idiosyncratic features are taken into account for the measurement of risks, which should be considered to the point to intensify the dialogue between the bank and its local supervisor in order to commensurate to capital requirements.

The specific characteristics of interest rate risk supports internal modelling, so highly standardized and prescriptive treatments will not be sufficiently risk sensitive and could address in an inaccurate assessment and management of IRRBB and disruption between economic capital management and regulatory capital.

Currently, a large number of financial entities have an internationally presence in a variety of jurisdictions and currencies, therefore the regulatory IRRBB framework should adequately capture the inherent risks, recognizing the benefits of diversification between different currencies.

Given the major differences in the nature of IRRBB risk we do not believe that a Pillar 1 treatment is appropriate for IRRBB, and that it should be retained within Pillar 2.