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Mr J Lund & Mr T Tsuiki
Co-chairs, Task Force on IRRBB
Basel Committee on Banking Supervision
Centralbahnplatz 2
Basel, Switzerland

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Dear Messrs. Lund and Tsuiki

BCBS Consultative Document on Interest Rate Risk in the Banking Book

The Banking Association of South Africa ("BASA") appreciates the opportunity to comment on the Basel Committee on Banking Supervision's ("BCBS" or "the Committee") Consultative Document on Interest Rate Risk in the Banking Book, issued on 8 June 2015 (referred to as the "CP" in this response letter).

Interest Rate Risk in the Banking Book ("IRRBB") is a particularly challenging area, and we would therefore like to commend the Committee on the thoroughness of the proposals contained in the CP.

The management of IRRBB is of great importance to the South African banking sector as it forms a key risk management tool used to produce stable and predictable earnings for shareholders, thereby also increasing the level of security provided to depositors and other providers of funding. IRRBB needs to be carefully managed by South African banks due to a number of characteristics of our market:

- South African banking book operations which consist predominantly of floating rate assets, funded at least in part by rate insensitive liabilities and equity, leading to a risk of compressed margins in downward rate interest rate cycles if not carefully managed.
- Exposure to basis risk between assets which are predominantly linked to the Prime lending rate, and liabilities which are often linked to the Johannesburg Interbank Agreed Rate ("Jibar"), with limited liquidity in hedging instruments available to hedge this risk.
- For certain large South African banks, the ownership of subsidiaries across the African continent (referred to as "Broader Africa") where the markets are characterised by large exposures to rate insensitive liabilities (referred to as "structural" liabilities), combined with low levels of liquidity in, and a general lack supply of, longer dated investment instruments which can be used to offset the interest rate risk generated by these

structural liabilities. The situation is further exacerbated by underdeveloped derivative markets with a general lack of interest rate hedging instruments.

- Interest rate risk management processes for subsidiaries in Broader Africa which are closely linked to liquidity risk management, often posing conflicting aims.
- An interest rate environment in South Africa and Broader Africa where interest rates tend to be higher, and substantially more volatile, than rates currently being experienced by more developed economies.

To address these challenges, most South African banks have already developed comprehensive interest rate risk management strategies, and internal models which are used to support these strategies. Banking book products are generally simple in nature and absent of complex embedded options, which help to alleviate some of the challenges outlined above.

BASA is a member of the International Banking Federation ("IBFed") and our members have participated in the Institute of International Finance ("IIF") debate on the CP. The South African banking sector supports the views expressed by the IIF, the IBFed, the Global Financial Markets Association ("GFMA") and the International Swaps and Derivatives Association ("ISDA") in their comprehensive response on the CP (referred to as the "IIF response" for the remainder of this letter). In particular, we would like to note our support for the following aspects raised in the IIF response:

- The view that a Pillar 1 approach is not appropriate for IRRBB. The South African banking sector has characteristics which deviate from those of more developed economies (such as the United States and Europe) which mean that any form of Pillar 1 approach is highly unlikely to be appropriate in the context of the markets our banks operate in.
- The preference for a Pillar 2 approach. We would however like to reiterate the concerns raised in the IIF response regarding the compulsory disclosure of the Pillar 1 risk position under Pillar 2. As mentioned above, the Pillar 1 approach is unlikely to provide an accurate reflection of the IRRBB position of South African banks due to the specific features of our market, and disclosure of Pillar 1 results is therefore likely to mislead and confuse our investor base.
- The concerns raised regarding the extent of public disclosures under Pillar 2. The South African banking sector is highly competitive and certain information currently being proposed for public disclosure would be deemed proprietary.
- The position expressed in the IIF response letter that any capital requirement should consider potential loss of capital rather than variability risk.
- The concerns raised with regards to the restrictive nature of the Pillar 1 proposals and the fact that these will not allow banks to accurately reflect the underlying risk in respect of Non-Maturity Deposits ("NMD's"), the investment of equity, behavioural options, basis risk, shock scenarios and currency aggregation. We provide examples in this letter of areas where the Pillar 1 proposals are of particular concern to South African banks.

We comment below on aspects specific to the South African banking sector (including subsidiaries based in Broader Africa), and do not repeat the generic points already made in the IIF response. Points previously made by industry regarding the potential arbitrage between the banking book and the trading book are also not repeated here.

The Appendices provide a number of examples in support of the points made below.

1. Technical aspects, particularly regarding the approaches for behavioural options, the earnings overlay and basis risk

- South African banks make extensive use of Annual Earnings at Risk ("AEaR") as a risk measure for IRRBB. It is also a metric which is used by the local analyst community. We would therefore advocate the use of AEaR as a primary tool for the measurement and management of IRRBB.
- As outlined earlier on this response letter, the typical structure of banking books in South Africa is such that assets are predominantly floating rate in nature. Liabilities tend to be more complex from an interest rate risk perspective with a combination of structural liabilities, managed rate liabilities, fixed rate liabilities and floating rate liabilities. We expect client behaviour, in respect of aspects such as prepayment and early redemption, to be very different in South Africa from more developed economies. We would also expect that these behavioural options are likely to be impacted by, inter alia, overall economic conditions, the distribution of wealth across market participants and the propensity of consumers to save. We deem the South African market to have material differences from more developed economies in these areas, so that the South African banking sector cannot support an overly prescriptive framework in respect of behavioural options, such as that currently contained in the Pillar 1 proposals.
- The challenges with a standardised set rules in relation to behavioural options in South Africa are even more pronounced for Broader Africa where there are substantial cultural and economic differences across the continent. Balance sheets in Broader Africa tend to be more volatile and interest rate environments can change at short notice.
- South African banks are exposed to Prime-Jibar basis risk, due to Prime-linked assets being funded at least in part by Jibar-linked liabilities. The risk is quantified by banks, but limited tools are available for hedging this risk. We are concerned with the proposed level of complexity of the proposals relating to basis risk and feel the risk could potentially be covered through a simpler measurement approach.
- The banking book operations of South African banks across Broader Africa also suffer from basis risk, exacerbated by a general lack of market rates and instruments to manage this risk. It is likely to be challenging to quantify basis risk to the level of granularity and sophistication prescribed by the CP given the general lack of market information.
- The CP proposes a "gone concern" approach to interest rate risk measurement rather than a "going concern" approach. We support the concerns raised by the IIF regarding this approach, and would like to point out that the issue is likely to be even more pronounced for South African banks. Balance sheets of South African banks (especially those with African subsidiaries) can change substantially over time, with many banks achieving double digit balance sheet growth rates in certain regions. Modelling interest rate risk on a "gone concern" basis is unlikely to provide an accurate reflection of the emerging levels of interest rate risk inherent in the business.

2. Specification and values of the standardised risk parameters as well as constraints on the own estimate risk parameters

- We are concerned with the level of standardisation prescribed in the CP - in particular the prescriptive treatment of interest rate stresses, non-maturing deposits, and equity are of concern as a "one size fits all" approach is unlikely to work across different banks and different geographies given likely differences in product sets and customer behaviour. We also note that this level of standardisation might not provide a sufficient incentive for banks to develop their own internal models to ensure that IRRBB is accurately measured, especially if doing so will result in risk parameters that fall outside the standardised ranges provided.
- Interest rates in South Africa are currently higher than those in most developed economies such as Europe and the US, with the policy rate in South Africa (referred to as the "Repo" rate) currently at 6% p.a., and the Prime lending rate at 9.5% p.a. In many Broader African countries, interest rates are even higher than those in South Africa. It would appear that the standardised parameters in the CP were not determined with such higher interest rate environments in mind, meaning that in most cases the prescribed caps will apply. This is unlikely to provide an accurate reflection of the underlying interest rate risk present in these markets.
- There are examples of NMD's in the South African banking sector which exhibit much longer behavioural lives than prescribed in the CP and with pass-through rates outside the ranges prescribed in the CP. Using the prescribed parameters could therefore potentially misstate the interest rate risk exposure of South African banks.
- South African banks with subsidiaries in Broader Africa generally have substantial structural liability exposures which exhibit very low interest rate sensitivity and which are behaviourally very long. The prescribed parameters could potentially lead to a material misstatement of the interest rate risk position within these businesses.
- Given the structure of South African banks' balance sheets, with most of assets being of a floating rate nature and a reasonably large proportion of liabilities and equity being of a rate insensitive or fixed rate nature, South African banks have to manage their interest rate risk position very carefully to ensure ongoing earnings stability. Approaches used by different South African banks vary, and range from formal hedging programmes to using other risk management techniques, such as allowing for the offsetting impact of reduced credit losses during periods of lower interest rates. Regardless of the actual risk management processes used, we are of the view that a single prescribed modelling approach in respect of Equity (e.g. requiring banks to profile this as an overnight exposure) would not be appropriate as it would not allow banks to reflect their actual underlying interest rate risk management strategies in order to stabilise earnings over time. It could potentially also force banks to change their risk management strategies due to the potentially large impact on capital requirements of deviating from the prescribed approach.
- A prescribed profiling approach for exposures such as equity could force all South African banks to follow the same hedging strategy, thereby leading to concentration around certain tenor points in the local swaps market. This could potentially increase the level of systemic risk present in the economy.

- We would recommend that standardised parameters are set by local supervisors, taking local conditions into account. A set of guidelines could potentially be made available by the Committee for the determination of the parameters in order to ensure consistency in approach across different regions.

3. Specification, selection and calibration of the prescribed interest rate shock scenarios

- We do not believe that the shock scenarios (and related caps and floors) have been determined taking the level of volatility in interest rates in South Africa and Broader Africa into account. As such, we are of the view that the shock scenarios are unlikely to provide a reasonable measure of the potential variability that could be experienced in the level of interest rates during a stress.
- Should the Committee decide to proceed with a prescribed set of shock parameters, we would recommend that local supervisors are allowed to apply national discretion to ensure that the shock scenarios are set at a level which takes local market conditions into account. The prescribed caps and floors should either be scrapped, or also be made subject to national discretion.
- The proposed holding period of 6 months for the interest rate shock calibration seems very long in the context of the markets in which South African banks operate and we would request that the Committee considers a shorter time period.
- Given South Africa's deep and active interest rate derivatives hedging market and the significant liquid asset portfolios that banks hold with a variety of fixed rate maturities, some/most/all of the banks could materially change, hedge or even reverse their fixed rate mismatch for the stress scenarios proposed (excluding basis risk) within days or weeks. The proposed 6 month holding period is then clearly too conservative, which has resulted in the extreme levels of rate shock proposed. Based on historic rate moves, we could certainly change our exposure before rates move by 400-700bp.

4. Specification of the candidate minimum capital requirements calculations

- AEaR could be used for the reasons outlined earlier in this response letter.
- We are of the view that banks cannot be expected to capitalise against variability in earnings, but that any capital should rather be held against potential loss of capital.

5. The mandatory disclosure of the standardised framework under the Pillar 2 alternative

- South African banks operate in a highly competitive environment and the currently proposed level of disclosure will not be feasible, as it would require banks to disclose parameters which form part of banks' pricing strategies.
- Also as outlined earlier, we do not believe that the compulsory disclosure of the Pillar 1 risk position under Pillar 2 is appropriate, as it is unlikely to provide an accurate reflection of the IRRBB position of South African banks.

- We support the view expressed in the IIF response that Credit Spread Risk in the Banking Book ("CSRBB") should be excluded from the scope of the CP and addressed separately. We would further point out that the challenges and limitations regarding the definition and measurement of CSRBB are likely to be more pronounced for Broader Africa, where data are likely to be even more sparse than in more developed economies.
- Regarding Principle 9, we would like to note that banks should evaluate variability risk for IRRBB as part of the broader scenario analysis and stress testing exercises conducted by the bank as part of its capital planning exercises. This approach will ensure that potential losses due to interest rate variability are included when setting capital buffers.
- We support the view expressed by the Committee in Principle 11 that supervisors should have specialist resources in the area of IRRBB. However, we would like to point out that South Africa and Broader Africa suffer from skills shortages and that it may not be possible to obtain the requisite skills in the market. This could potentially pose a challenge for local regulators if the required monitoring standards are set at an unduly high level.
- We agree with Principle 12 that outlier banks should be identified and more closely managed. However, we feel that the process for determining outliers should be left to national discretion to appropriately take the specific features of the local market into account.

6. Information as to how the standardised framework measure compares to banks' internal interest rate risk in the banking book measures

- South African banks have developed internal measurement approaches based on the nature of their balance sheets and the interest rate risks they are exposed to. Behavioural options, such as prepayment risk on fixed rate loans, are generally less material to South African banks. It remains important for South African banks to measure these risks, but it is important that prescribed measurement approaches are "fit for purpose" and not overly complex.
- As a result of the relatively low volume of fixed rate lending business conducted in South Africa, pipeline risks are also likely to be less material than is the case for certain other economies.
- NMD's and structural equity exposures are profiled by some South African banks based on underlying product behaviour and taking cognisance of the relevant bank's interest rate risk management approaches. Whereas the overarching aim is to stabilise earnings variability over time to within acceptable levels given the bank's risk appetite, the approaches used by South African banks in order to achieve this aim varies significantly. An overly prescriptive approach to the risk profiling of equity, for instance, would not be practical in light of the different approaches taken.

The South African banking sector remains committed to robust risk management practices in the area of IRRBB which is an important risk in our market. However, we do not believe that the proposals contained in the CP will help achieve this aim.

Consistent with the IIF response letter, the South African banking sector remains supportive of an “unrestricted” Pillar 2 approach, with reduced disclosure requirements.

We would be very happy to discuss any comments or questions you may have in response to this letter.

Yours sincerely

A handwritten signature in black ink, appearing to read 'G Haylett', with a stylized, cursive script.

Gary Haylett
General Manager – Prudential

Appendix 1 – Volatility in short-term interest rates and level of disparity across African markets

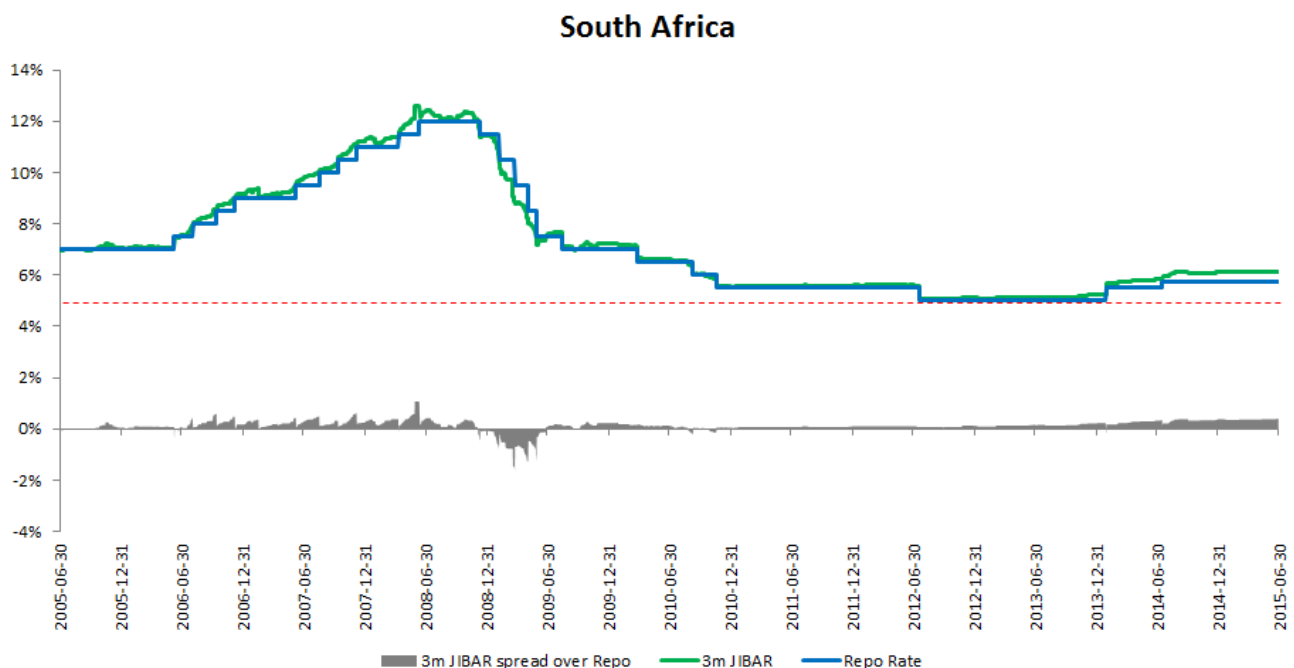
The potential for losses in a rising interest rate environment is primarily relevant to developed markets which have been at exceptionally low interest rate levels for an extended period of time. The existence of substantial fixed rate loan books in these markets have led to the risk of significant earnings compression and potentially losses in some entities as interest rates begin to rise to more 'normal' levels. In these markets depositor behavior may differ significantly between placing in zero or low interest bearing accounts (i.e. current accounts) versus accounts linked to the prevailing market interest rates once interest rates start to rise.

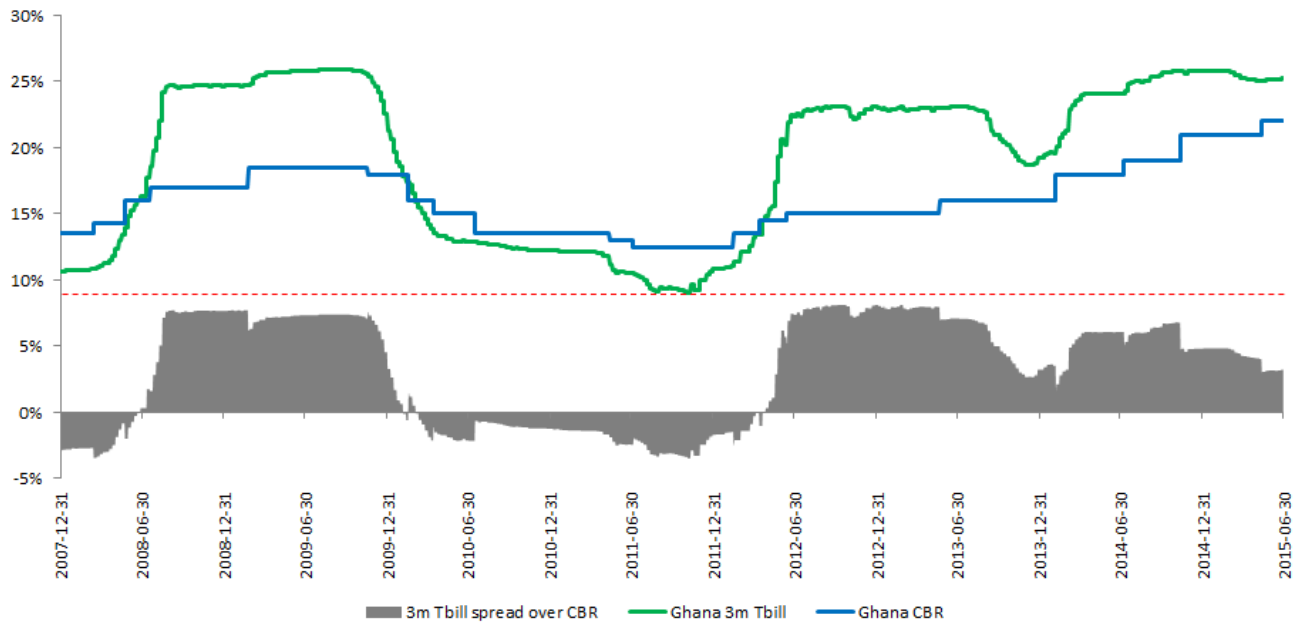
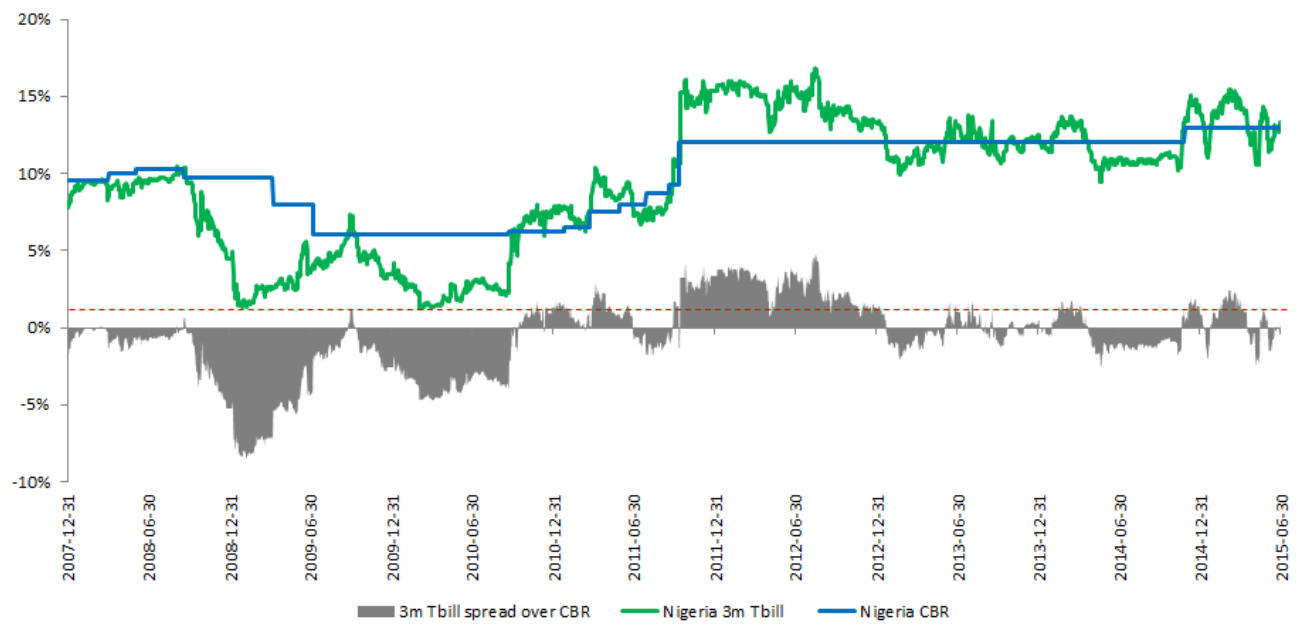
Market dynamics in South Africa and Broader Africa differ to the above as:

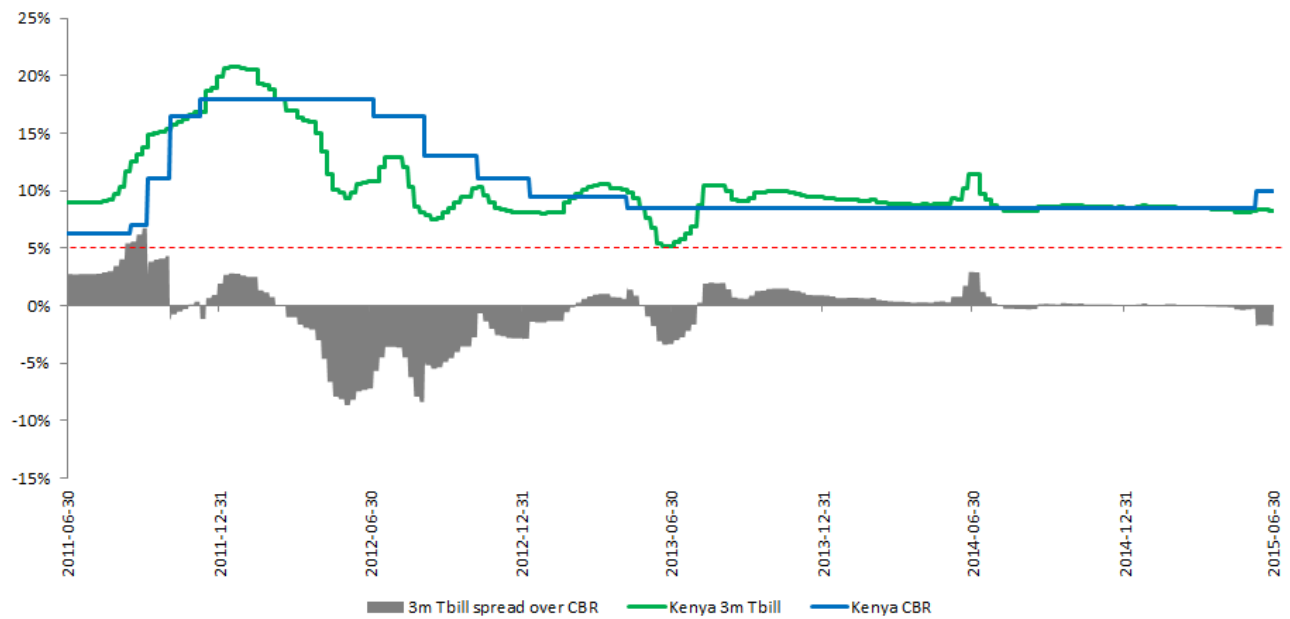
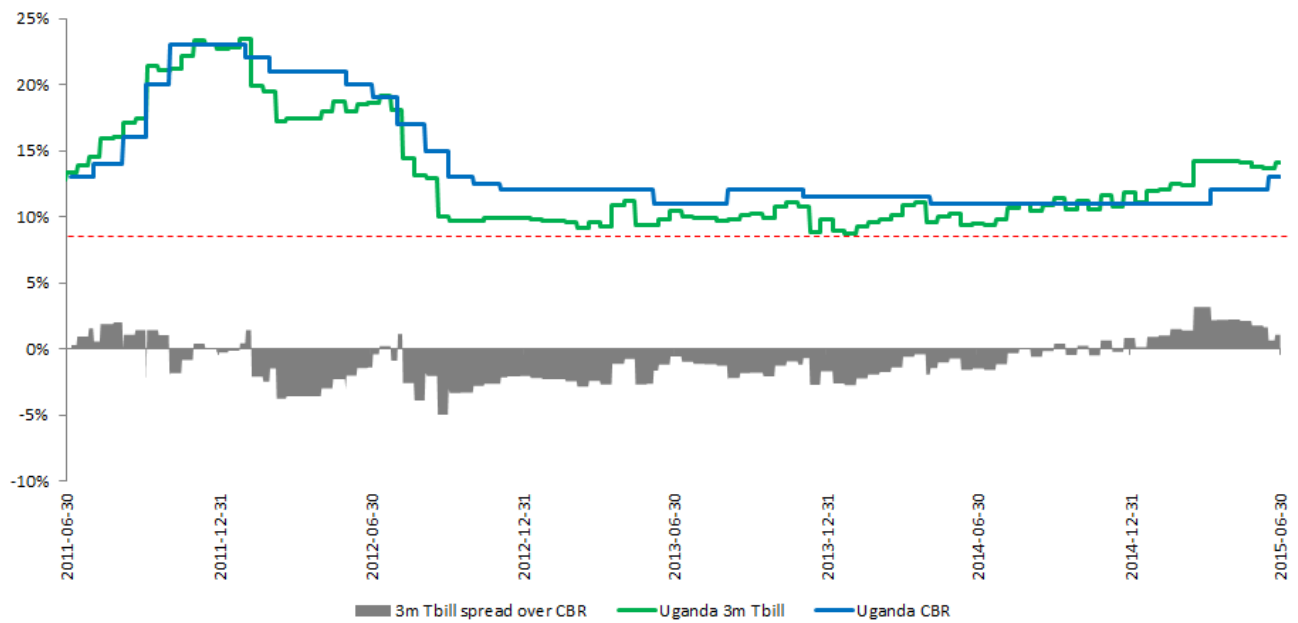
- The majority of loans are floating rate – fixed rate loan portfolios are small in comparison to the overall loan portfolios
- Where interest rates are near historically low levels the level of interest rates are still sufficiently high enough to encourage depositors to place in accounts paying market related interest rates. As such balances kept in non-remunerated or low interest bearing accounts are not expected to reduce significantly from an increase in interest rates alone.

Given the balance sheet structure of the majority of banking entities in our markets, which have mainly variable rate loan books funded in part by low or non-interest bearing accounts, during a rising interest rate cycle net interest income will increase. This is seen as a natural offset to higher credit impairments and losses that may occur as a result of rising interest rates, particularly given the floating nature of loans in our markets.

The application of standardised shock measures and basis risk calculations across all markets is not appropriate given the large disparities across markets. This is further illustrated below for selected African markets. In particular, the volatility in interest rates, as well as the large disparity across markets, should be noted.



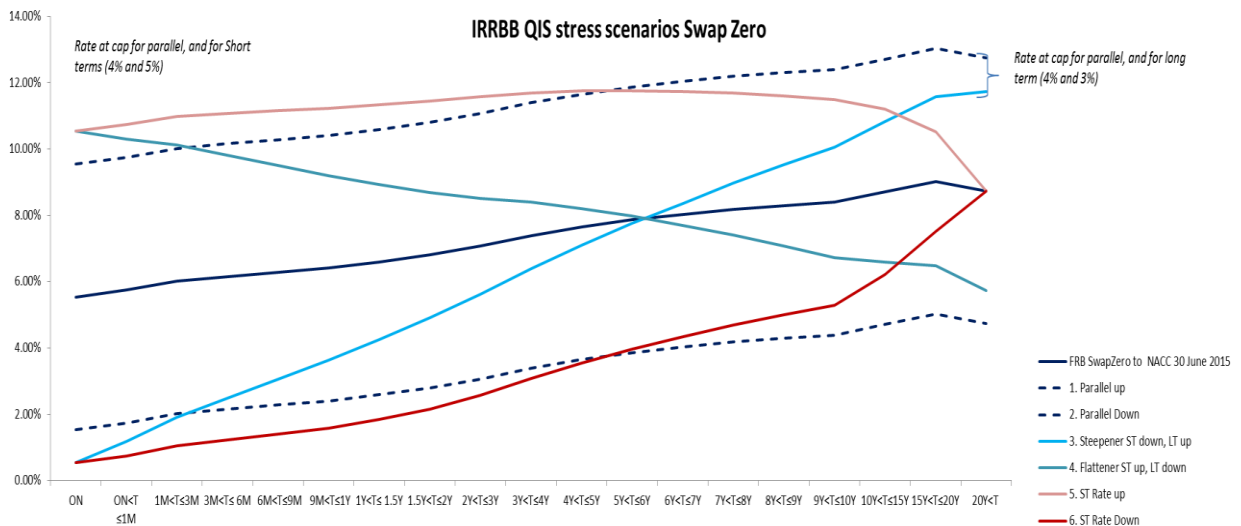
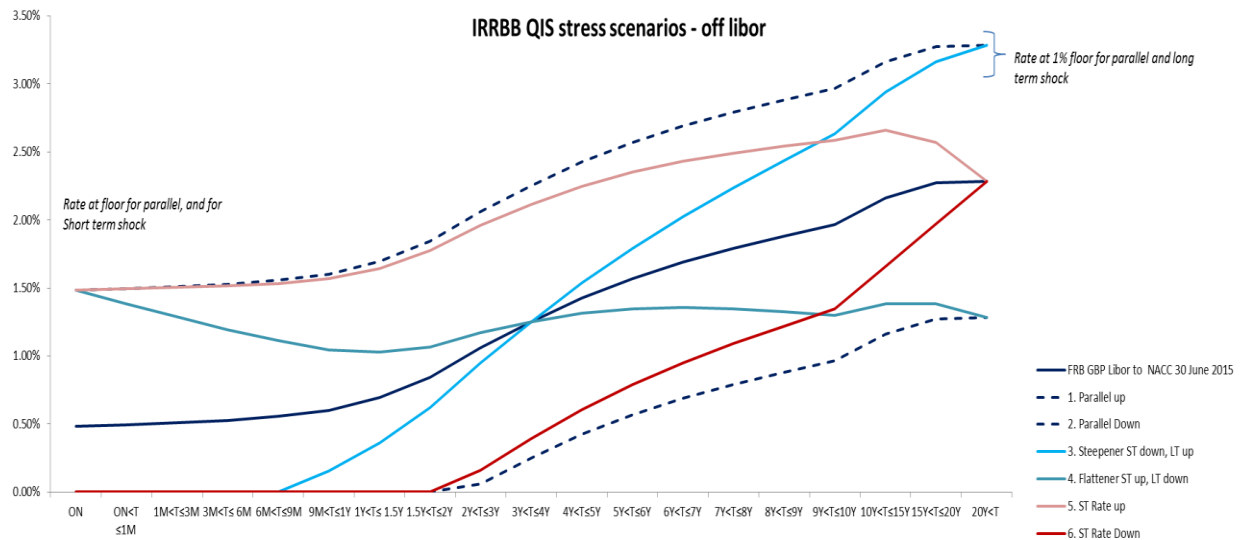
West Africa:**Ghana****Nigeria**

East Africa:**Kenya****Uganda**

Appendix 2 – Calibration of shock scenarios

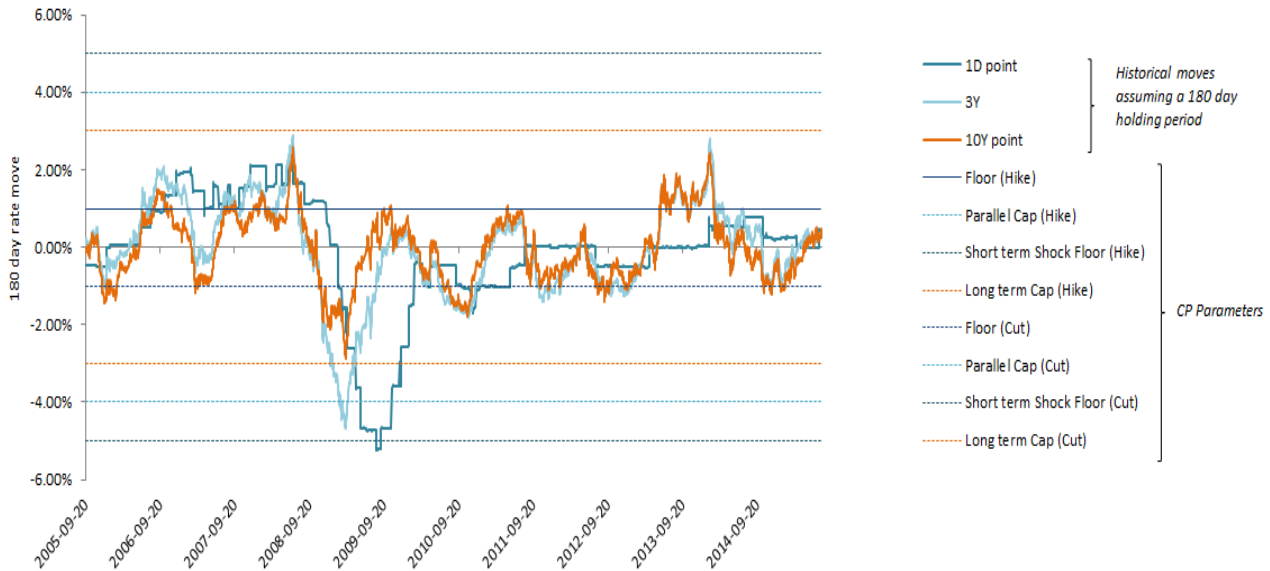
Markets in South Africa are facing a similar normalisation cycle to UK and US banks. However, the level of rates in SA is at an elevated level given higher inflation levels in SA. As a result, the shock parameters provided for the QIS, which were calibrated off Libor rates are excessively punitive on SA banks relative to foreign banks. In terms of a standardized metric to be used globally, the calibration of the rate shocks, needs to be set by jurisdiction so as to not possibly distort the risk to banks in emerging markets. To illustrate this, please see below. Using the GBP Libor and ZAR Jibar rates, the curves for each scenario were recalculated.

Using the Libor curve as a base, rates were calibrated to the floor/ 1% specified in the document, where as for Jibar estimated by the SA Swap Zero curve, rates were capped. As a result, an EVE calculated off these rates would result in a more significant impact in SA, and most likely in other emerging markets where the level of rates is higher. Additionally, this is most likely to remain at a constant level given that in the low rate environment the caps are already triggered. We therefore do not believe that a percentage shock calibrated off libor is a fair reflection of all markets and would urge the task force to allow for national discretion for jurisdictions. Regulators should also consider using an absolute shock as opposed to a percentage of current rates.



Assuming a 180 day / 6 month holding period, the graph below shows the historical movement relative to the caps and floors provided in the CP. The below considers data from the swap zero curve over the period 31-Dec-04 to 31-Jul-15. This includes a from peak to trough rate cycle between 2006- 2010. Given that in this low rate environment, risk free rate triggers CP caps, one would assume that in a higher rate environment, this would still be the case.

Historical Rate moves Jibar



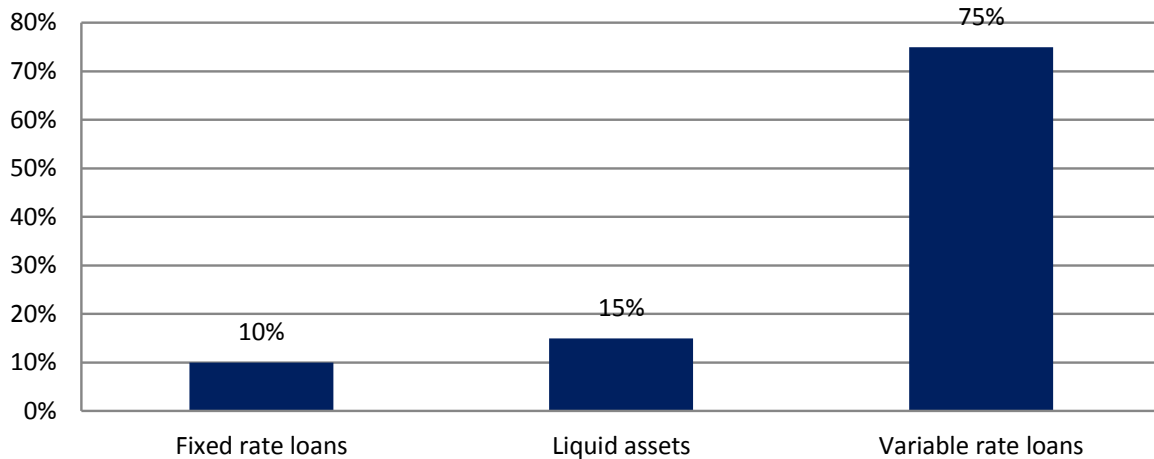
The impact of an excessively aggressive scenario, could lead to a misinterpretation of the risk. The graph below calculates the EVE for the scenarios as specified in the CP using Libor shock and Jibar shock using the reported, industry repricing gap not adjusted for behavioral assumptions in relation to deposits and capital.



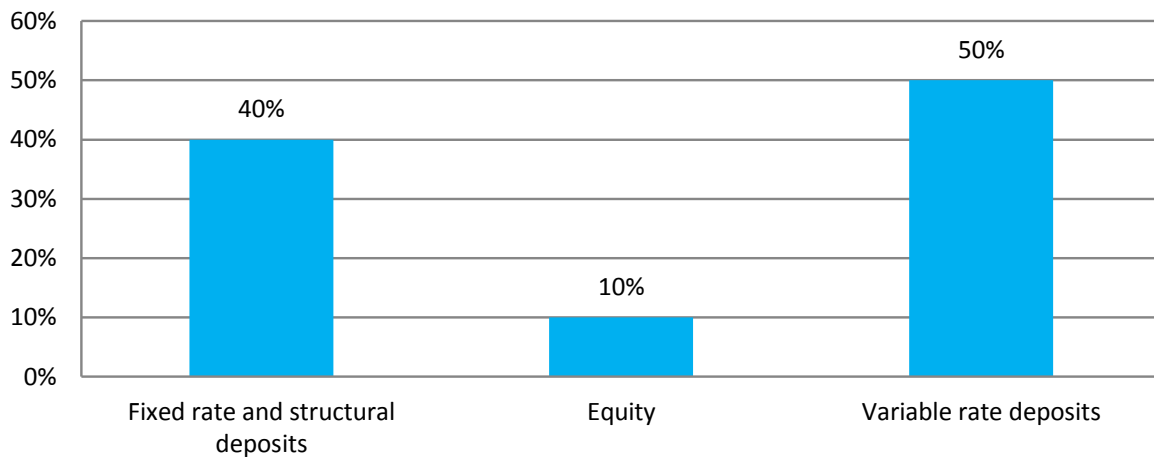
Appendix 3 – South African balance sheet structure and exposure to margin compression risk

For the purpose of illustration, a bank which operates exclusively in South Africa could have a balance sheet composition as outlined in the graphs below (before hedging):

South African banks - illustrative composition of asset base



South African banks - illustrative composition of liabilities and equity



When interest rates reduce, 75% of the total asset base will re-price on an overnight basis, producing lower interest income for the bank (assuming the full liquid assets portfolio consists of fixed rate instruments). On the other hand, only 50% of the liability base will re-price on an overnight basis, thereby reducing the interest cost paid by the bank. The bank is therefore exposed to the risk of margin compression during a downward rate cycle, because more assets are affected by the reduction in interest rates than liabilities.

Should interest rates increase, the bank is positioned to benefit from margin expansion, as 75% of the assets will benefit immediately from increased interest income, whereas only 50% of liabilities would become more expensive immediately after the increase in interest rates.

South African banks use a range of different approaches to stabilise their interest margins in light of this typical balance sheet structure:

- Certain banks follow formal hedging strategies, under which receive-fixed, pay-floating swaps are used to convert the fixed rate and structural rate liability exposures to a floating rate to match the asset base.
- Other banks hedge on a more tactical basis, based on their views for future movements in interest rates and the risks they are exposed to.
- Certain banks use reduced credit losses during a downward rate cycle as an offset for the margin compression likely to be suffered.

This example demonstrates the margin compression risk faced by South African banks. As banks have different approaches towards the management of this risk, it would not be appropriate the Committee to prescribe the re-pricing behaviour of equity for the purpose of managing IRRBB.

Appendix 4 – Deposit sensitivity

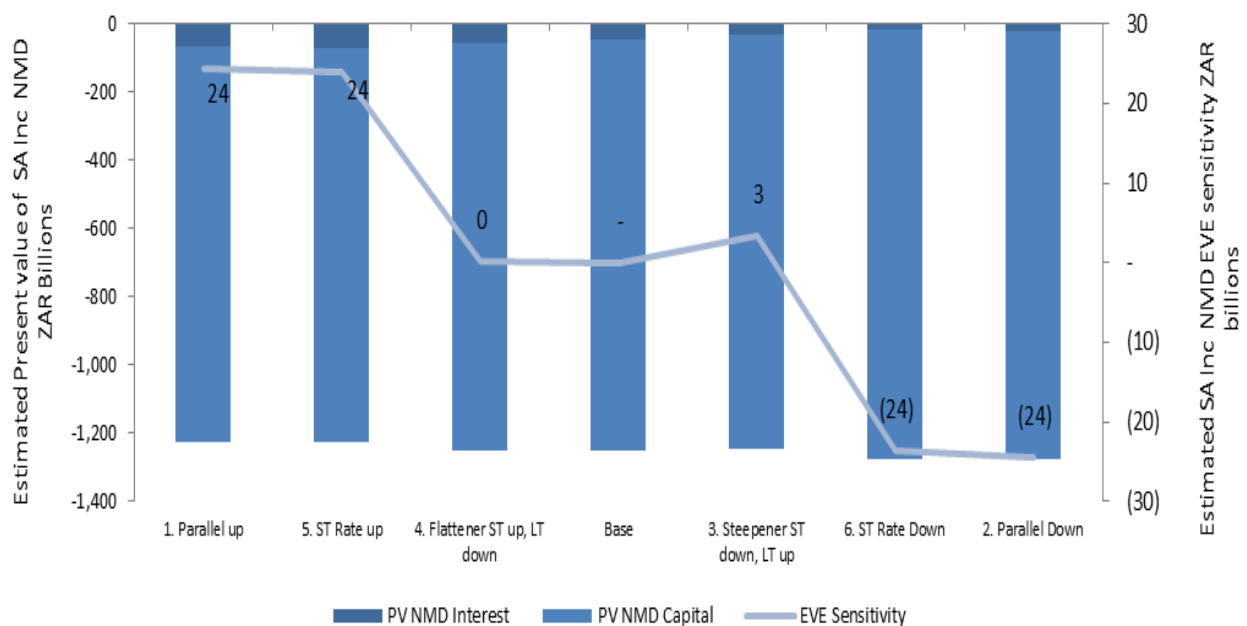
SA banks primary concern is to manage earnings stability through the cycle. Given that the bulk of advances written on the banking book are floating rate, the behavior of deposits results in significant earnings sensitivity often referred to as endowment impact. Banks may choose to manage this to a profile, or else to manage strategically in line with the macro-economic view and risk limit and appetite considerations. Additionally, where there is not an available hedging market to minimize this risk, management may choose to monitor and accept this risk as a consequence of ordinary banking activities. Should all banks in SA chose to manage their deposit franchise based on a longer term behavioral profile as a result of a pillar 1 charge being imposed, this could result in possible concentration risk in the market as banks would all be positioned in a similar way.

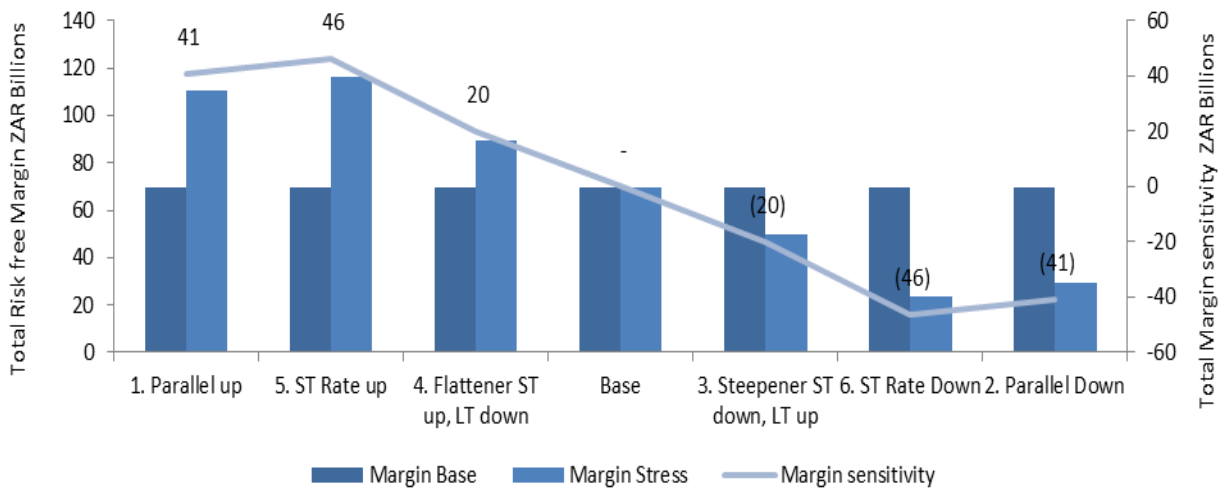
The graphs below demonstrate the economic and earnings sensitivity of SA Inc deposits. These workings were completed based on the June 2015 BA900 deposit for the industry. Cheque, saving, demand and call deposits were included and allocated between Retail and wholesale based on product and depositor classification.

Given SA predominantly floating advances, these deposits were assumed to have been invested in the risk free rate. As evident in the graphs below, the earnings sensitivity is more volatile than an economic sensitivity metric. If managed appropriately with risk limit and appetite levels, and within a strong governance environment, this can be a source of value to the group's margins.

The illustration below also shows that for the same profile a simplified TIA is preferable than to invest in robust modeling process which may increase the modeled risk. This is particularly the case where deposits are not used as a natural hedge to underlying fixed assets. The focus of IRRBB should not be to optimize capital cost, but to accurately model risk.

Estimated EVE and earnings sensitivity measures for SA Inc assuming Simplified Time Series approach with uniform slotting:





Estimated EVE and earnings sensitivity measures for SA Inc assuming Time Series approach with uniform slotting, and Stability caps and pass through parameters

