

Secretariat of the Basel Committee
on Banking Supervision
Centralbahnplatz 2
4051 Basel
Switzerland

Zurich, 11 September 2015

Re: Interest rate risk in the banking book - consultative document

Dear Sir/Madam,

UBS would like to thank the Basel Committee on Banking Supervision ("BCBS") for the opportunity to comment on the consultative document ("CD") "Interest rate risk in the banking book".

UBS understands the underlying reasons for which the BCBS has been assessing the regulatory capital treatment and supervision of interest rate risk in the banking book ("IRRBB"), namely that banks should continue to have appropriate capital to cover potential losses from exposures to changes in interest rates and that incentives for capital arbitrage between the trading book and the banking book, as well as between banking book portfolios that are subject to different accounting treatments, should be limited. We, however, believe that the current regulatory, audit and internal oversight of IRRBB in the main jurisdictions in which we operate, including its models and management, is both rigorous and adequate and we have a number of important concerns with the current proposals and their likely consequences.

Please find below our comments on the most important aspects set out in the consultative document, from a UBS perspective. Our response should be considered complementary to the Joint Associations' Response to the BCBS IRRBB consultative document¹ to which we also contributed and which we strongly support.

Banks, in their traditional model (performed by the banking book), **carry out a core economic function which plays a vital role for the economy** namely **through so-called "maturity transformation,"** where they take contractually short-term sources of funding, such as deposits, and offer longer-term credits, thereby providing certainty of cash-flows to both households and businesses. This not only supports economic growth in allowing increased capital investment, but, more importantly, it also reduces the effects of the interest rate cycle on an inventory-led business cycle.

It is important to note that in the case of non-maturing deposits ("NMD") this is only a "maturity transformation" when viewing the *contractual* maturity of the NMD (as such

¹ The Institute of International Finance (IIF), the International Banking Federation (IBFed), the Global Financial Markets Association (GFMA), and the International Swaps and Derivatives Association (ISDA).

deposits typically can be withdrawn at short notice). **However, crucially, this does *not* constitute a maturity mismatch when considering the NMD's actual behavioral, i.e., effective maturity.** A significant portion of on-demand deposits exhibit longer-term behavior both in terms of their interest rate ("IR") re-pricing (the main thrust of IRRBB) and with respect to their funding value – but whereby their behavioral IR re-pricing maturity and their funding maturity are generally distinct.

Clearly, under a severe funding/liquidity stress situation, the behavioral funding maturity of NMDs can collapse and thereby automatically shorten the IR re-pricing behavior (leading – exceptionally – to a convergence of both maturities). But such an impact on IRRBB is a *contingent* effect caused by the funding/liquidity stress. While this possibility should clearly be covered in banks' routine assessment of their funding and liquidity resilience as well as their capital adequacy when spanning all risk categories, it should not be treated as if it were a standalone component of IRRBB.

The CD's proposed approach to NMDs would effectively force banks to ignore the true, effective IR re-pricing characteristics of their deposit base and instead to manage their IRRBB under the constant assumption of a severe funding/liquidity stress situation. Apart from misrepresenting a bank's inherent IRRBB exposure in the normal course of business, this would detrimentally affect the stability of a bank's earnings, hinder its ability to offer fixed-rate term loans and it would force banks to pass on interest rate risks to their clients on both sides of the balance sheet. However, we certainly continue to share the view that banks must exert due caution in their IRRBB modelling of NMDs such that they prudently account for potentially significant shifts and/or re-pricing in deposit volumes that can be triggered by interest-rate movements.

We therefore fear that the proposals, in their current form, would strongly impair the important economic transmission role of banks and believe that interest rate risk is better left to be borne by institutions that are best equipped to manage this risk factor (rather than forcing clients to bear it).

From a **methodological perspective**, our main considerations are the following:

- We believe that **capital should only** be required to **underpin the risk of loss of capital** and not the risk of fluctuations in (positive) earnings, as the latter do not deplete capital when earnings remain non-negative.
- In its current form, the proposal for capital underpinning is, from our perspective, **too focused on an Economic Value ("EV")** view that is point-in-time in nature. As a result, it lacks a proper earnings perspective and is too static. The valuation risk from discounting locked-in future margins, which are typically accrual-accounted and held to maturity in a banking book, should in particular not be considered as a risk to be underpinned with capital. The present value of future margins that accrue to income are not recognized in a bank's current capital base. Therefore a change in this present value due to valuation curve movements does not affect banks' capital. The use of the EV approach does not reflect the time dimension of how interest margin is earned in the Banking Book, i.e., accrued over time (in contrast to the Trading Book where margin is usually quantifiable up-front).
- In our view, the proposed **treatment of NMDs seems too restrictive and unrealistic** as it does not allow banks to properly represent the true, effective interest rate risk profile of their client deposits. In particular, the proposals are forcing the same assumptions on the modelling of the behaviour of customers' deposit in all jurisdictions, whereby customers do not necessarily behave in the same way in each country. In case NMD model risk is a main concern of the BCBS, we believe that this could more efficiently be addressed within the current Pillar 2 framework.
- The current proposal effectively assumes that all of the bank's equity is at risk overnight; it contains no test for whether there is an unrealized and unrecognized loss within the investment of equity process and how this would affect capital needs². **Forcing banks to treat equity as an overnight rate risk will likely result in higher earnings volatility** and will penalize banks who seek to generate a stable earnings stream from their equity over a rates cycle.

² In this context, we would like to make reference to the alternative proposal outlined in Appendix 4 of the Joint Associations' Response.

- The **treatment of NMDs and equity effectively assumes a severe-crisis situation**. Managing IRRBB based on effectively assuming a stressed funding/liquidity situation would lead to a scenario where, in a non-stressed environment, the inherent interest rate risk managed by banks may be misrepresented and potentially remain open due to the acknowledged simplification for a required regulatory standardisation across non-homogenous banking markets. We would recommend that such crisis scenario be rather assessed for capital adequacy in a comprehensive stress testing approach encompassing all risk categories.
- Our understanding is that **no attempt seems to have been made** by the BCBS to **ensure the integrity of economic modelling of NMDs**. The non-economic integrity of prescribed models and parameters will create real costs for the banking sector – and its clients – by further increasing banks' earnings volatility and hence their borrowing costs as well as causing higher-than-needed lending charges.

We believe that if implemented as proposed, the changes would lead to a misrepresentation of banks' interest rate risk in their banking books, which could have the following **potential unintended consequences**:

- **Banks' net interest earnings would be more volatile**, as banks would be forced to reinvest equity and NMDs at short durations. In other words, banks would be incentivized to adjust (i.e., significantly curtail) the interest-rate maturity structure of their balance sheet assets to reflect a regulatory prescribed duration profile for their NMDs and equity. This would particularly impact banks' loan offerings in the domestic economy.
- **Retail clients** in particular (especially in a country such as Switzerland) **would strongly suffer**:
 - **The costs to clients for** (long-term) **fixed-rate loans and mortgages** would **significantly increase**, as banks would no longer be able to offset the interest rate exposure through recognizing the effective long-duration components of their NMD base (nor through a target duration/investment of equity approach). By reducing the supply and tenor of fixed-rate products (or meaningfully increasing their cost), the proposals would in fact pass interest rate risk onto retail clients who have limited ability to hedge themselves.
 - Similarly, on the savings/deposit side, as the banks' investment horizon is capped, **depositors will be offered less protection against falling rates**, which would be much more directly passed onto them.
- **New concentration of risks would be created** due to bank treasuries and asset liability management functions being forced to crowd around similar hedging durations. This would create issues in many markets (including Switzerland) where there is limited market liquidity for interest-rate swaps.

We would be happy to discuss with you, in further detail, any questions you may have. Please do not hesitate to contact Dr. Bruce McLean Forrest (bruce-mclean.forrest@ubs.com; +41-44-239 67 66) or Kieran Sweeney (kieran.sweeney@ubs.com; +41-44-239 40 35).

Yours sincerely,
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