

POSITION PAPER



WSBI-ESBG response to the BCBS consultation on the interest rate risk in the banking book

WSBI (World Savings and Retail Banking Group)

ESBG (European Savings and Retail Banking Group)

Rue Marie-Thérèse, 11 - B-1000 Brussels

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WSBI



ESBG



Dear Sir/Madam,

Thank you for the opportunity to comment on the EBA consultation on *the interest rate risk in the banking book (IRRBB)*.

1. General comments

In ESBG's opinion, the Basel Committee on Banking Supervision (BCBS) proposes a highly standardised approach so as to calculate the capital requirement for interest rate risk in the banking book, both under the Pillar 1 approach and under an enhanced Pillar 2 approach. For the reasons presented below, we believe that both (too standardised) approaches are not appropriate for dealing with the IRRBB.

As we explain in detail in this document, in the case of the Pillar 1 approach, the treatment proposed for products such as non-maturity deposits (NMDs) and positions with behavioural options would lead to such a high level of standardisation of parameters that the actual level of interest rate risk in an entity would not be reflected appropriately. The constraints on the modelling of NMDs in the Pillar 1 proposal bear a very striking liquidity risk, and hence need to be considered as far too restrictive to correctly assess the interest risk component in NMDs. The unfavourable consequences could be very well seen in the treatment of current accounts.

Furthermore, the methodology proposed for capturing basis risk could even lead to an incorrect estimation of the interest rate risk.

Thus, we do not share the BCBS's views that the Pillar 1 approach would increase market confidence in a bank's capital adequacy. On the contrary, we rather believe that banks would have capital requirements different from those that they would actually need, since the standardised metric would not reflect their actual risk exposure. In addition, the lack of flexibility in the proposal could create volatility in a bank's earnings, as it leads, in some cases, to a modification of the duration regarding the bank's balance sheet.

ESBG also considers that the proposed standardisation would result in increased operational and technological burdens for banks. This, as a consequence, could then lead to a replacement of a bank's accurate and robust internal IRRBB measurement.

For positions where capital or interest rates are locked in for an undefined period, assumptions have to be made concerning the interest rate adjustment behaviour in the customer business. A standardisation would *de facto* force all banks to use universally applicable assumptions. The behavioural nature of the IRRBB – which is particularly true for retail and savings banks – cannot be captured by means of a one-size-fits-all approach. In addition, a uniform approach would lead to a strong convergence of banks' pricing behaviours and hence diminish healthy and self-regulating market competition and potentially increase systemic risk.

Generally speaking, ESBG is further concerned that a Pillar 1 model might even prove to endanger banks' ability to continue providing low-risk savings products to customers at the current levels. Banks might no longer be able to provide savings products to interest-insensitive customers or to provide savings products that are largely unattached to interest rate levels. At the same time, a capital charge resulting out of a flawed risk estimation will potentially have unintended consequences on the economy's loan supply.



We believe that the revision of the IRRBB framework should not lead to a further increase in capital for banks. Furthermore, one of our biggest concerns relates to capital charges that lack risk sensitivity and the compulsory hedging transactions that are inadequate with regard to the underlying risk and would therefore increase revenue volatility.

The Pillar 2 approach proposed in the consultation paper (CP) is actually not very different from the intended Pillar 1 approach, as it uses the standardised approach proposed for Pillar 1 for benchmarking purposes. This very restrictive Pillar 1 fall-back would be seen as a floor, and therefore it would be very difficult for supervisors to agree with any significant departure. Such Pillar 2 approach would be a 'Pillar 1 in disguise'.

In general, regarding an overly-high degree of standardisation, ESBG would like to emphasise that regional specificities, such as the various different market products offered in different countries, should not be standardised with worldwide one-size-fits-all elements. This would affect the banking sector in a negative and unwanted way, particularly the diversity of different business models and the profitability as well as capital accretion of a great number of banking institutions.

Given the inappropriateness of defining a highly-standardised one-size-fits-all approach, ESBG would support the idea of an improved Pillar 2 framework for the IRRBB without using the Pillar 1 approach as a benchmark. Today there is a tremendous international variety of frameworks existing across the EU and worldwide. While we understand the Basel Committee's intention to harmonise IRRBB treatments, we believe this can be achieved just as well with a common set of basic principles that would still allow for different methodological approaches.

ESBG underlines again that a standardised approach cannot be applied to non-maturing deposits given the difference in business models, markets, regulations and customer behaviour among banks. Banks should be allowed to use their internal models instead but conditional to robust internal validation and regulatory review.

With regards to the debate on the metrics, we consider that any future regulatory framework should recognise the importance of both the earnings as well as the economic value approach. A regulatory approach to the IRRBB should reflect this perspective as economic value losses seldom translate – through NII – into a loss of regulatory capital.

Finally, ESBG does appreciate the introduction of the proportionality principle (page 38 of the CP) in the context of the IRRBB, which shall ensure that a bank's nature, size, complexity, structure, economic significance and general risk profile are taken into account.

2. Specific comments

2.1 NMDs (section 2.5 of the CP)

In the context of the IRRBB, a number of instruments exhibit non-linear responses to changes in interest rates. In some cases, certain instruments have embedded options where the decision to exercise that option is driven by behavioural factors. Such factors are difficult to model, and even more difficult to standardise. In this respect, the proposed Pillar 1 framework allows the use of parameters obtained from banks' internal models, but subject to restrictions.



In the particular case of (NMDs), the CP suggests that, under the proposed Time Series Approach (TIA), NMDs must be segmented into retail and wholesale NMDs. In a second step, they should be split into stable and non-stable NMDs. For this purpose, volume changes over the past 10 years should be used. The stable NMD subset would be the portion that will most likely remain undrawn. However, the stable NMD subset it would be subject to a category-dependent stability cap of 80%. In a third step, the stable subset of NMDs is further broken down into a core and a non-core component. To achieve this, a pass-through rate is applied to determine the rate-sensitive part of the stable subset. However, the second subset will be subject again to an imposed floor of 25%.

ESBG is not in favour of the proposed levels of caps and floors. In particular, the stability cap is too low and the pass through floor is too high, in our point of view. According to our experience, non-interest rate bearing current accounts regularly show a stability percentage up to 90%, and in the case of the accounts that remunerate 0%, the pass-through rate is usually close to zero. Based on this, the caps and floors proposed in the Pillar 1 approach would include an overestimation of the non-core deposits sensitivity. It could also lead to an increment of the volatility earnings, since, in accordance with the CP, they must be slotted into the overnight time bucket.

Core deposits would need to be slotted in time buckets of up to six years, which means that a bank would be forced to slot the NMDs, using a lower maturity than it would usually assume. This could push up the economic value (EV) volatility of global balance sheets, for instance, in those cases where the assets of the entity pay fixed rates.

In the following example, ESBG would like to illustrate the severe impact that the proposed caps, floors and duration for NMDs could have on risk exposure in the banking book. This example is based on the analysis of a real time series of non interest rate bearing current accounts from one of ESBG's members.

Let's assume that a bank has 3.659 million current accounts that do not remunerate the customers (i.e. customer rates = 0%). As they do not remunerate them, the accounts are non-interest rate bearing current accounts (NIBCA). One should expect that the portion of these accounts' balance, which is stable over the time, is high. Besides, one should expect that the sensitivity to changes of underlying market rates is not significant. The below charts show both the evolution of the balance and the rates remunerated against market rates for NIBCA accounts over the past 5 years.

Chart 1. Evolution of non-interest rate bearing current accounts balance (millions).

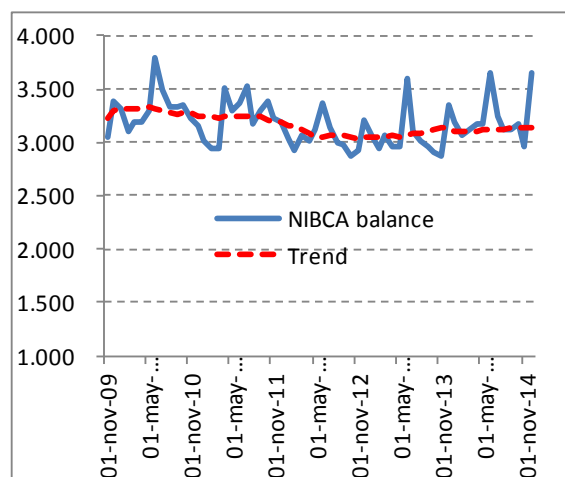
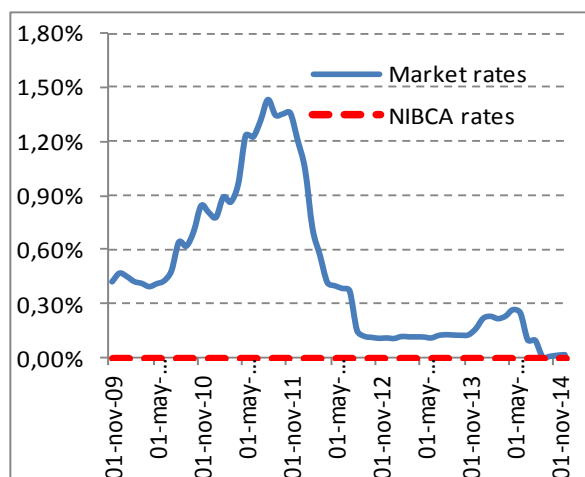


Chart 2. Non-interest rate bearing current accounts rates against market rate (Euribor rates).





The stable balance of the NMDs is calculated with reference to the monthly change in trend balance. In accordance with the data available, the stable portion of the NIBCA's balance analysed for this example represent 91% of the average balance of the last 12 months, i.e. around 2.924 million. Nevertheless, following the CP proposal, the bank would be forced to allocate as stable balance just 80%, i.e. around 2.579 million. Therefore, the bank would allocate as non-core balance, to overnight bucket, 345 million more than it would be expected to do following its internal methodology.

Table 1. Impact of stability cap and pass-through floor proposed in the CP.

	% Stable Balance	% Core Balance	Stable Balance Millions	Core Balance Millions
Estimated with internal model	91%	100%	2.924	2.924
BCBS proposal	80%	75%	2.579	1.934

In a second step, the core ratio of the stable balance identified for NIBCA's is calculated as $(1 - [\text{NIBCA rate change} / \text{change in underlying market rate}])$. The ratio $[\text{NIBCA rate change} / \text{change in underlying market rate}]$ represents the pass-through rate mentioned in the CP. As the NIBCA's customer rate is zero, it is evident that the value of this pass-through rate will be zero. Hence, the 100% of the stable balance identified should be allocated as core balance. But, as the pass-through floor proposed in the CP is 25%, just 75% of the NIBCA's stable balance would be allocated as core balance, and 25% would be considered as non-core balance. In other words, this would mean that, following the CP proposal, the aforementioned bank would be forced to move from core to non-core an additional 645 million in the NIBCA's balance (see table 1 above). The total impact of putting in place both the stability cap and pass-through floor proposed is an increment of the non-core balances of around 1 billion. The allocation of such an amount as non-core, and its slots to overnight bucket, would result in an increase of the bank's earnings volatility by 10 million in the parallel scenario (see table 3 below).

Table 2. Weight of time buckets for core NMDs under uniform slotting.

Internal Methodology									
Millions	ON	ON<T≤1M	1M<T≤3M	3M<T≤6M	6M<T≤9M	9M<T≤1Y	1Y<T≤6Y	6Y<T≤10Y	TOTAL
Core Balance	0	24	49	73	73	73	1.462	1.170	
Non Core Balance	735								
Total Balance	735	24	49	73	73	73	1.462	1.170	3.659

BCBS Proposal									
Millions	ON	ON<T≤1M	1M<T≤3M	3M<T≤6M	6M<T≤9M	9M<T≤1Y	1Y<T≤6Y	6Y<T≤10Y	TOTAL
Core Balance	0	27	54	81	81	81	1.612	0	
Non Core Balance	1.725								
Total Balance	1.725	27	54	81	81	81	1.612	0	3.659



Let's further assume that in accordance with the bank's internal models, the maturity profile of the identified core balance is a monthly amortising notional, straight line profile, of 10 years. Following the proposal of the CP, the maturity should become shorter, more precisely 5 years.

The reduction of the duration of the core balance, together with the decrement of the balance of this type of product would lead to a significant decrease of the economic value of equity (EVE) volatility in the liabilities side, as table 3 below shows. We assume that, in accordance to the internal models, the core balance of the NIBCAs is completely offsetting the sensitivity of fixed-rate loans on the asset side of the bank, i.e. the risk exposure due to assets position = risk exposure due to liabilities position. In this case, reducing the NIBCAs' duration would lead to increasing the EVE volatility of the total balance sheet (see table 3). In summary, the bank would allocate capital due to an earnings and EVE volatility higher than the volatility that it manages internally.

Taking the above arguments into account, we would like to underline that, in case the assets of the bank were floating rate loans, the global EVE volatility of the bank would be lower than the volatility that it manages, and hence it would allocate less capital than it should do.

Table 3. Impact in EV and net interest income (NII) both of stability caps/ pass-through floor and a shorter duration for NMDs.

EV volatility of NMDs.

	Parallel Up	Parallel Dn	Steepener	Flattener	Short Rate Up	Short Rate Dn
Internal Model	134	-102	47	-48	100	-79
BCBS Proposal	56	-21	4	-2	47	-21

EV volatility of fixed rate loans (*).

	Parallel Up	Parallel Dn	Steepener	Flattener	Short Rate Up	Short Rate Dn
Internal Model	-134	102	-47	48	-100	79
BCBS Proposal	-134	102	-47	48	-100	79

(*) Trying to make it simple, we assume that the bank prepayment treatment = prepayment treatment of the CP.

Global EV volatility of the bank.

	Parallel Up	Parallel Dn	Steepener	Flattener	Short Rate Up	Short Rate Dn
Internal Model	0	0	0	0	0	0
BCBS Proposal	-78	80	-43	45	-52	58



NII volatility of NMDs and total entity.

	Parallel Up	Parallel Dn
Internal Model	-7	-1
BCBS Proposal	-17	-2

2.2 Behavioural options (section 2.6 of the CP)

According to the CP, behavioural options (baseline estimates of loan prepayments, loan draw-down rates and early withdrawal of fixed term deposits), could be calculated based on internal assumptions. However, in a second step, these baseline estimates are multiplied by the supervisory determined scalars that, in conformity with the CP, should reflect the likely behavioural changes in the exercise of the options, given a particular interest rate shock scenario.

As this scalar depends on the volatility of the interest rates – instead of the level of rates – it could lead to early cancellation assumptions, different from those used by a bank based on more accurate models. This in turn could again lead to a risk measurement that is different from the one analysed by the entity.

On the other hand, behavioural options implicit in floating rate positions seem to be ignored. This could have a significant impact on the average maturity of the automatic options embedded in those contracts and hence their market value.

In the following example, with the help of the figures from one of its members, ESBG would like to illustrate this circumstance. Let's assume that a bank has 13.7 billion of floating rate loans with embedded bought floors with a 3.5% strike. Let's assume that the bank has estimated a prepayment rate of 6% annually for the floating rate loans. In addition, let's say that assumptions in relation to bad debt rate are put in place, too. In accordance with this assumption, the present value (PV) of these options is 0.7 billion. Nevertheless, the bank, following the CP proposal, would report a value of 1.3 billion. This figure would represent double what is managed internally due to the contractual maturity of loans that must be used for estimating the options value.

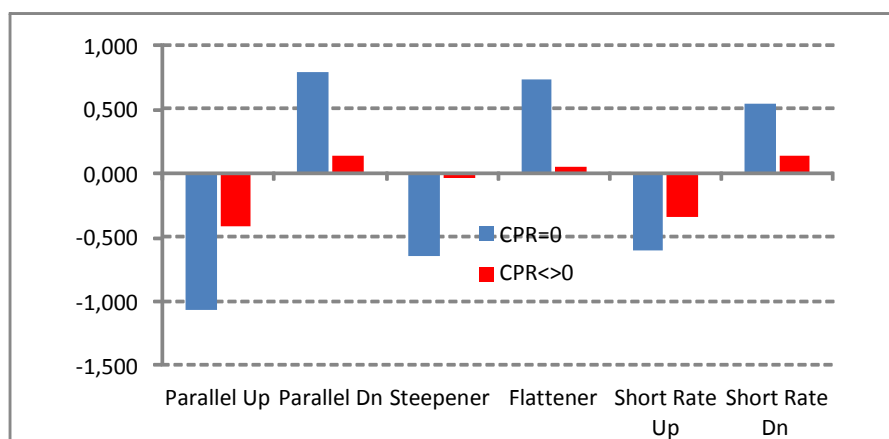
Table 4. Present value of embedded bought floors under different assumptions on loans prepayment (CPR)

	CPR=0	CPR<>0
PV Billions	1,3	0,71
PV % Notional	9,2%	5,2%

Due to the maturity of the loan, and hence the maturity of the options which is higher than the maturity calculated based on any assumption on prepayments, the EV volatility of automatic options would be higher than the volatility managed internally, as the table below demonstrates. So the bank would again be forced to allocate more capital than it intended to do.



Chart 3 and Table 5. Economic value volatility of embedded bought floors under different assumptions on loans prepayment (millions)



EV Variation

	Parallel Up	Parallel Dn	Steepener	Flattener	Short Rate Up	Short Rate DN
CPR=0	-0,70	1,20	-0,31	0,54	-0,49	0,51
CPR<>0	-0,44	0,39	-0,08	0,15	-0,37	0,30

Finally, ESBG would like to emphasise that the use of internal models should be allowed in respect of dealing with the behaviour of non-amenable positions, such as NMDs and behavioural options, since these entail a more realistic representation of the risk exposure of the bank.

2.3 Automatic interest rate options (section 2.7. of the CP)

According to the CP, positions on bought automatic interest rate options that are not used for hedging sold automatic interest rate options are exempted from the calculation of the capital requirements regarding the interest rate risk. If these transactions are recognised though P&L based on fair value – and, in consequence, are fully reflected in the capital position of the entity – they could be included in the capital requirements calculation.

From ESBG's perspective, this is inconsistent with the treatment that the rest of the positions in the balance sheet would receive under the proposed Pillar 1 approach. They would not be reflected in the capital position. In spite of this, a capital charge would be put in place based on the expected variation of their economic value. We therefore support the idea that positions on bought automatic options which are not used for hedging sold automatic interest rate options are not exempted from the calculation of capital requirements.



2.4 Net interest income (NII) and basis risk (section 3 of the CP)

While not explicitly dealt with in the CP, ESGB assumes that the NII measure would be subject to a mandatory 1 year time horizon. From our point of view, this would be a very short period to fully capture the interest rate dynamics that are implicit in the balance sheet.

We therefore suggest that the standardised approach should allow an NII measurement higher than 1 year, subject to different interest rate curves and shock scenarios, including steepening and flattening scenarios apart from the two parallel scenarios proposed in the CP. In doing so, a more realistic NII estimation could be expected. Furthermore, the calculation of an add-on due to basis risk would not be necessary (as it would be implicit in the NII calculation).

In relation to the basis risk measurement added to the NII metric, the methodology proposed could lead to an incorrect estimation of this type of risk. For the estimation of the short-term, non-parallel gap risk, the proposed methodology would aggregate heterogeneous repricing balances. Moreover, it would apply shocks to the combination of all reference rates. In consequence, it would consider the same impact for the cumulative repricing balance, regardless of their fixing tenor. In practice, a 1 month fixing would have 11 months of impact in the NII, a 3 month fixing would have 9 months of impact in the NII, and so forth.

On the other hand, for the reference rate basis risk, the proposed methodology would aggregate interbank rates at different tenors. So it would ignore the fact that instruments repricing at different tenors have different underlying curves, characterised by different dynamics and hence different risk impacts.

In addition, it is proposed to apply standard shocks of 50bp and 20bp to every pair of reference yields (50bp in the case of reference rate basis risk measurement, and 20bp for short term, non-parallel gap risk metric). This would result in a wrong estimation of the basis risk due to the reference rates aggregation.

2.5 EV and basis risk (section 3 of the CP)

The fact that transactions in the balance sheet reprice at different tenors, as well as different reference curves, would also be ignored in the transaction cash flows estimation for the calculation of EVE measurements. This seems inconsistent with regard to the assumptions done in relation to future cash flows, implicit in the pricing of other positions, such as automatic options. In these cases, the payoff is the function of an underlying tenor, and hence an underlying curve. Meanwhile the expected cash flows are discounted using a different curve (risk-free curve).

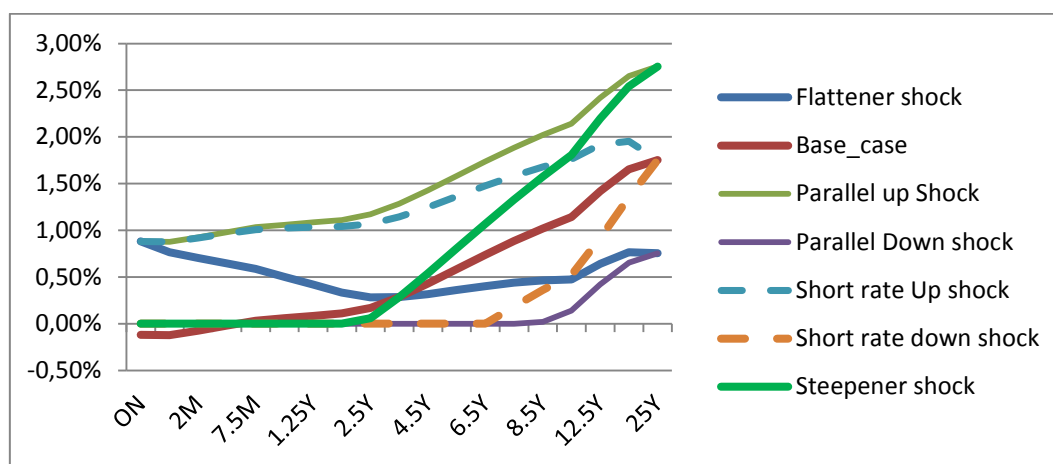
From our point of view, the full revaluations of the transactions included in the balance sheet that are different from automatic options – including forward cash flows estimations – should be included in the EVE estimation. This would increase their consistency with the pricing procedure of other positions in the balance sheet, such as automatic options. In addition, it would increase the comparability of this measure with the NII.



2.6 Interest rate shock specification (section 2.2 of the CP)

The CP proposes an interest rate shock calibration that could, in some circumstances, lead to unrealistically low interest rate shocks for some currencies and unrealistically high interest rate shocks for others. To address this concern, a floor of 100bp would be applied to all interest rate changes as a result of the interest rate shock scenarios in order to ensure a minimum level of prudence and a level playing field. In addition, the post-shock interest rates may also need to satisfy the following zero lower bound condition, i.e. interest rates cannot be negative.

Chart 4. Interest rate risk shock scenarios



In the current context, some references of the interbank market are already negative. Ignoring this fact could lead to an overestimation of the margin-compression effect that a bank is exposed to, in a shock scenario of falling rates. Due to funding costs of the balance sheet approach to zero bound, asset yield would continue to fall. ESBG would like to illustrate this fact with the help of the following example.

Let's say that a bank has loans of EUR 100 million to Euribor 12M, and they are funded with interbank deposits to Euribor 1M flat. Currently the Euribor 12M is around 0.16%, and the Euribor 1M is around -0.10%. In a shock scenario of a parallel interest rate shock of -100bp, one would assume that the Euribor 12M will fall 16bp, and in the case of the funding, one would assume that the Euribor 1M would increase by 10 bp. In this context, while earnings would decrease by EUR 80,000, the funding cost would increase by EUR 91,667 in a year. As a result, the NII volatility would be EUR 171,667. Nevertheless, if we assume that rates could achieve negative values, the decrease in the earning of loans would be partially or completely (this depends on the shock assumed) to the additional decrease of the cost of funding. So the volatility of the NII would be lower. On the other hand, curves in the parallel shock down scenario would be very similar to a flattener shock scenario, as is shown in chart number 4 above.

Different to what is assumed in the CP, prepayments are very often not interest-rate driven. According to Recital 66 of Directive 2014/17/EU (Mortgage Credit Directive), a legitimate interest in an early repayment may, for example, occur in the events of divorce or unemployment. Therefore, a simplified interest-rate driven prepayment model could not reflect the risks correctly.



2.7 *Disclosure requirements*

In spite of favouring the maintenance of the IRRBB in the Pillar 2 framework, we disagree with certain aspects proposed by the BCBS, such as Principle 8, which forces institutions to disclose quantitative and qualitative information on IRRBB requirements. One needs to be careful with this since current Pillar 2 requirements are not subject to disclosure and some of the items analysed in it are confidential and could affect the banks' competitiveness or market access. Tables 14 and 15 propose relevant information on the IRRBB to be disclosed that ESBG does not consider appropriate.

Art. 448 CRR obliges banks to disclose information on their exposure to interest rate risk on positions not included in the trading book. Concretely on (i) the nature of the interest rate risk and the key assumptions (including assumptions regarding loan prepayments and behaviour of non-maturity deposits), and frequency of measurement of the interest rate risk; and (ii) the variation in earnings, economic value or other relevant measures used by the management for upward and downward rate shocks according to management's method for measuring the interest rate risk, broken down by currency. We consider that it is sufficient information to be disclosed.



About WSBI (World Savings and Retail Banking Institute)

WSBI brings together savings and retail banks in all continents and represents the interest of circa 6,000 financial institutions with total assets of USD 14 trillion and serving some 1 billion customers in 80 countries worldwide (2013 figures). As a global institution, WSBI focuses on international regulatory issues that affect the savings and retail banking industry. It supports the aims of the G20 in achieving sustainable, inclusive and balanced growth and job creation around the world, whether in industrialised or less developed countries. WSBI favours an inclusive form of globalization that is just and fair, supporting international efforts to advance financial access and financial usage for everyone. It supports a diversified range of financial services that meet customers' transaction, savings and borrowing needs responsibly. To these ends, WBI recognizes that there are always lessons to be learned from savings and retail banks from different environments and economic circumstances. It therefore fosters the exchange of experience and best practices among its members and supports their advancement as sound, well-governed and inclusive financial institutions.



World Savings and Retail Banking Institute - aisbl

Rue Marie-Thérèse, 11 ■ B-1000 Brussels ■ Tel: +32 2 211 11 11 ■ Fax : +32 2 211 11 99

Info@wsbi-esbg.org ■ www.wsbi.org

About ESG (European Savings and Retail Banking Group)

ESBG brings together savings and retail banks of the European Union and European Economic Area that believe in a common identity for European policies. ESG members support the development of a single market for Europe that adheres to the principle of subsidiarity, whereby the European Union only acts when individual Member States cannot sufficiently do so. They believe that pluralism and diversity in the European banking sector safeguard the market against shocks that arise from time to time, whether caused by internal or external forces. Members seek to defend the European social and economic model that combines economic growth with high living standards and good working conditions. To these ends, ESG members come together to agree on and promote common positions on relevant matters of a regulatory or supervisory nature.

ESBG members represent one of the largest European retail banking networks, comprising of approximately one-third of the retail banking market in Europe, with total assets of €6,749 billion, non-bank deposits of €3,415 billion and non-bank loans of €3,685 billion (31 December 2013).



European Savings and Retail Banking Group – aisbl

Rue Marie-Thérèse, 11 ■ B-1000 Brussels ■ Tel: +32 2 211 11 11 ■ Fax : +32 2 211 11 99

Info@wsbi-esbg.org ■ www.esbg.eu