



*European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken*

EACB
**Contribution to the discussion on Interest Rate Risk in
the Banking Book (IRRBB)**

Brussels, 23rd September 2014

The voice of 3.700 local and retail banks, 56 million members, 215 million customers

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Executive Summary

The discussions at the level of the Basel Committee and the Task Force on Interest Rate Risk (TFIR) on potential regulatory steps concerning the treatment of interest rate risk in the banking book (IRRBB) and the capital requirement for credit spread risks (CSRBB) in the banking book are likely to have a significant impact especially on cooperative banks. It is of key importance to design a coherent regulatory framework and to avoid overlaps with other regulatory provisions (e.g. the Liquidity Coverage Ratio, the Fundamental Review of the Trading Book).

To this purpose we believe that the following points should be considered in the design of the treatment for IRRBB and CSRBB:

1. We believe that a Pillar 2 approach would be the best tool to accommodate in the most effective way the supervision of IRRBB. Given different bank's business models, portfolio structures and depositors' behaviors and characteristics it is difficult to establish a globally uniform "standardized approach" for interest rate risk. Under a Pillar 2 approach institutions' risk managements would be allowed to model their individual parameters in the most sensitive and appropriate way.
2. We believe that an enhanced Pillar 2/Pillar 3 approach could assess interest rate risk in the banking book much more effectively, for example through: the establishment of clearer supervision process; the new regulatory approach on the sufficiency of "the required amount of capital (Tier 1 capital)" against "the amount of IRRBB"; the introduction of enhanced disclosure rules on "IRRBB".
3. There is no need for the development of a standardised Pillar 1 requirement for the IRRBB and the CSRBB. Such a requirement might well be overly detrimental for the sound management of credit activities. A standardised Pillar 1 requirement would lack the sufficient and necessary sensitivity and flexibility to reflect institutions' differing business models, balance sheet structures, products, and customers behaviours. This would lead to significant deviations from the measurement of actual risk exposures. In this context we believe it is of the utmost importance to highlight that:
 - a. the specification of a standardised regulatory model, would not take into account the different balance sheet structures, would impact the actual management of IRRBB, and affect unnecessarily hedging strategies. It is therefore of paramount importance that institutions are allowed to maintain their well established and tested internal methodologies;
 - b. it is extremely dangerous to specify a one size fits all approach for the modelling of non-maturity deposits (NMDs) whose characteristics are institution and jurisdiction' specific;
 - c. the interaction with other Pillar 1 measures should be taken into account in order to avoid regulatory overlaps.



1. A Pillar 2 approach allows differentiated and risk sensitive supervision

As explained above, there are sound reasons that prevented the emergence of uniform standards for the measurement and management of interest rate risk. In order to capture the impact both on revenues and on equity, or on the financial position, some banks feature the complementary use of individual measurement approaches. Moreover, for non-maturity deposits (NMD), assumptions for the interest rate have to be made with regard to the future interest rate adjustment and the predicted behaviour of customers. A standardisation would *de facto* force all banks to use standardised assumptions. This may create clear incentives for an alignment of the risk management (and of customer product policy) with supervisory requirements. Bank's business models vary because their portfolio structures and depositors' appetite and characteristics differ. As such, it is difficult to establish a globally uniform "standardized approach" for interest rate risk, since key elements in interest rate risk measurement greatly differ among countries. Against this backdrop, banks have been managing their interest rate risk under Pillar 2 since the introduction of Basel II, and accordingly established appropriate management frameworks while allocating necessary resources to such management. This situation has remained unchanged.

In the past, the supervisor used to ask banks to develop their own approaches for reflecting the interest rate risk under Pillar 2 preferably on the basis of their own business strategy/corporate policy. Yet, the current discussion implies a development headed into the opposite direction. Nevertheless, there is a noticeably wide range of differences between the several individual approaches based on the different product policies, business strategy and the future adjustment behaviour; it is self evident that each bank needs to accommodate its individual parameters in banks' risk management. Hence, banks need to be free to set individual, bespoke parameters allowing them to forecast their clients' interest sensitivity as accurately as possible. This is the only way for correctly reporting the interest rate risk and avoiding any undesirable effects.

1.1 Suggestion for an enhanced Pillar 2/Pillar 3 approach

We therefore believe that an enhanced Pillar 2/Pillar 3 approach could assess interest rate risk in the banking book much more effectively. To this end a number of actions could be considered:

- the establishment of clearer supervision process such as capital/risk management through integrated risk management (i.e. economic capital frameworks), ICAAP implementation, and supervisory process (such as annual reviews and regulatory monitoring) on the basis of the above results;
- new regulatory approach on the sufficiency of "the required amount of capital (Tier 1 capital)" against "the amount of IRRBB". Following the assessment regulatory action is taken where necessary (IRRBB shall not be directly incorporated in the denominator and numerator of capital adequacy ratio). There is little reasoning for mandating "8% capital" against interest rate risk. A supervisory approach should be considered whereby the amount of capital is compared and assessed against the total amount of risks, including interest risk. In fact, IRRBB differs from the risk management in trading book, where



materialized risk will immediately result in the impairment of capital through the profit and loss account.

- introduction of enhanced disclosure rules on "IRRBB". At the moment, there is room for banks' discretion as to disclosures on IRRBB in both current and consultative Basel Pillar 3 requirements. While, we oppose to standardised capital requirement for IRRBB, we believe that enhanced disclosures of IRRBB methodologies could benefit supervisory appreciation.

2. Disadvantages of a Pillar 1 treatment of IRRBB

We believe that a simple and standardized sensitivity based model for the calculation of a Pillar 1 requirement for IRRBB would be distant from banks' own risk management practices and would lack the necessary flexibility to take into account the specificities of different business models, institutions, products, and client behaviours.

IRRBB already has full recognition and is best treated under a Pillar 2 approach. In addition, the "Basel interest rate shock" is sufficiently risk-sensitive and gives the supervisor a fundamental overview concerning the interest rate risk in the banking book and the risk bearing capacity of each bank. Due to the inter-dependencies between Pillar 1 and Pillar 2 requirements, interest rate risk considered under Pillar 2 already impacts Pillar 1 requirements.

Furthermore, we would like to emphasize our concerns about the results of the "mini-QIS" already carried out and in particular on the representativeness of that exercise. We therefore ask the TFIR to consider especially smaller banks in the survey that will follow the publication of the discussion paper during fall of 2014. Such an exercise should in fact involve institutions from different business models and of different size and complexity.

We are also concerned by possible capital requirement for credit spread risk from own account investments. Credit spread risk is closely linked to counterparty risk (default risk and migration risk). Hence, credit spread risk is sufficiently covered by the existing supervisory rules. For banking book exposures, credit spread changes are usually irrelevant. We strongly recommend not to design an additional capital requirement for CSRBB.

2.1 A Pillar 1 requirement may not reflect actual risk exposures and would not allow institution to apply their tested and coherent internal methodologies

The specification of a standardised Pillar 1 requirement and calculation methodology may lead to significant deviation from the actual risk exposures and to difficulties to capture the complexity related to interest rate risk modelling. This is especially true when it comes to factor in the behavioural optionality in assets and liability and derivation of risk profiles of non-maturing deposits (NMDs) and equity that by their very nature are institution dependent. Institutions should continue to apply their own models in order to determine the tenor and volume over time of such exposures. The specification of a standardised regulatory model, would not take into account the different balance sheet structures, would impact the actual management of IRRBB, affect the hedging strategy



(for instance pushing towards an increase of hedging transactions), result into higher earnings' volatility and lower level of retained earnings.

In order to avoid any misguided incentives in the area of risk management, we believe that banks' internal measurement methodology should be maintained. For a significant number of co-operative banks the Net Interest Income-method (NII), and for many others the Economic Value at Risk approach are the preferred methodologies. Both methodologies have been tested and tried, they are understood in an unambiguous manner by the controlling department, and senior management can easily interpret them. If a Pillar 1 requirement is to be specified, then it should only be based on an approach that is in line with banks' internal control systems. Otherwise, the potentially forthcoming supervisory rules might result in conflicting management inputs. In an international environment, banks either use the Net Interest Income or Economic Value at Risk approach; there are also some banks where both approaches are applied on a complementary basis, on the other hand hybrid approaches are unheard of and furthermore not helpful.

A capital charge lacking risk sensitivity may result in compulsory hedging transactions that are inadequate with regard to the underlying risk, increased revenue volatility, a reduction of the low-risk transactions due to an erosion of margins, a concentration process concerning the business policies and shorter maturities in the lending business. At the same time, an inappropriate capital charge will potentially have unintended consequences on the credit supply to the real economy.

2.2 The modelling of different behavior of depositors is highly institution' specific

One of the most important elements in the interest rate risk measurement in the banking book consists in an appropriate modelling of different behavior of depositors. To this end, many co-operative banks use the tested and tried model of the moving average. By using the moving average model, the bank obtains an appropriate idea of the volume, the investment duration and the interest rate sensitivity.

The moving average assumptions are modelled on both historic observations and additional future scenarios. They reflect the major influence factors: the way in which deposits built up in the past as well as seasonal effects or campaigns, the future interest rate adjustment behavior and business model. These assumptions are subjected to regular stress tests and validation.

Therefore, in principle a uniform supervisory rule on the clustering of exposures (NMD's) as well as a supervisory regime for the assignment of durations would lack an adequate degree of risk differentiation. For instance, a regulatory measure that standardizes the treatment of NMDs and equity, by assuming them to have short investment terms, could lead banks to shorten the overall duration of their balance sheets and/or cluster around the same investment horizon. This could lead to more volatile earnings, impact on customer pricing and products offered (e.g. a shift from fixed to floating rates products). In a worst case scenario this could even potentially pose a systemic risk instead of strengthening financial stability, for example by transferring interest rate risk to customers thus giving rise to default risk when the interest rate scenario changes significantly.



The duration and the interest rate of these deposits are determined by the respective bank's product policy and they reflect the interest rate adjustment. Determining the interest rate adjustment behavior is part of the managing strategy. We believe that this entrepreneurial freedom shall and may not be restricted by supervisory rules.

In light of the above, also in a potential supervisory model, there is a compelling need to give all banks the opportunity to continue using their tested and tried approaches and to continue drawing upon parameter settings geared to their individual position.

Furthermore, it should be noted that stable characteristics of deposits in institutional networks of cooperative banks are already well recognized in the Basel III framework for liquidity purposes (LCR and proposed NSFR). Therefore, these unique stable deposits features should be modelled with sufficient sensitivity and flexibility also for interest risk purposes, leaving national supervisors the discretion to recognize a dedicated treatment for such deposits.

In order to appropriately capture banks' interest rate risk, risks on the liability side should also be taken into account based on their effective characteristics, while factoring in the business model, depositors' behaviors, and/or regulation.

We hold the view that there is a paramount need for a differentiation depending on the respective risk under observation. Therefore, we need to separate the interest rate risk and the liquidity risk. After all, the liquidity risk is already covered at a different juncture.

2.3 The interaction with other Pillar 1 measures has to be taken into account

Attentions should also be paid to avoid conflicts other measures such as the LCR currently being implemented in various jurisdictions. In fact, while the LCR will require banks to hold a certain amount of high quality liquid assets (typically government bonds) in the banking books, imposing capital charges on interest rate risk against such assets may trigger conflicts between the rules and hardly impair the aim of regulation. Therefore, at least, due consideration is required so that high quality liquid assets should be exempted from the scope of capital charges on IRRBB.

2.4 A Pillar 1 measure would not factor in risk diversification

In terms of appropriately managing risks of the entire portfolio, supervisory review should take into account the risks of assets as a whole, rather than capture interest rate risk in isolation. Interest rate risk is borne and should be controlled while striking balance with other risks. A Pillar 1 measure would not take into account the diversification effects among assets, and the interactions between credit and interest rate risk. This will result in an inconsistency between desirable risk management and a framework facilitated by a Pillar 1 approach. Therefore, interest rate risk should be most appropriately treated under Pillar 2, through integrated risk management (i.e. economic capital frameworks).

2.5 Interest rate shocks are multifaceted

Asset impairment as a result of interest rate shocks should not be the only driver for the specification of a measure of capital soundness. A rise in interest rates does not always



“adversely” impact all financial institutions, in particular when they hold mortgages and loans at floating rates. This, in fact, may also eventually trigger a capital increase as a result of earnings growth. Since a rise in interest rates does not always push up funding costs to the same extent as portfolio yields, overall profitability could improve. Therefore the measure of the impact of interest rate risk on capital, should take into account not only deterioration in unrealized gains/losses due to interest rate shocks but also the impact of improvement in holding period returns. In this regard, interest rate risk is considered to be most appropriately managed under Pillar 2, specifically, through stress testing with various time horizons as specified by ICAAP.

We welcome the idea to link the interest shock scenarios to the interest rate level of the respective currency. In our view, the number of scenarios should be limited. For instance, the following four scenarios would be sufficient for simulation purposes: parallel shift, steepening, warp and twist.

We believe that the standardized Economic Value at Risk approach (simulation on the basis of historical data) covered even more scenarios since, under Pillar 2, many co-operative banks simulate all historic scenarios from a specific point in the past. This internal measurement is a strong foundation for banks’ risk management as well as their interest rate risk management. Instead, an additional measurement method will cause duplication of effort and costs. We are concerned that if the regulatory capital is the restrictive factor, a potentially more simple approach will be preferred to a more meaningful approach, giving cause to wrong management decisions. The impacts on the revenues and the business model would be substantial, and the likelihood of undesirable side-effects would increase.

2.6 Capital requirement for CSRBB

In our understanding, the underlying rationale for reviewing the need for a CSRBB consists in reducing the scope for regulatory arbitrage between the banking book and the trading book. In this context, we would like to highlight the work conducted by the BCBS’ Trading Book Working Group. In our view, the BCBS’ Trading Book Working Group has already removed any incentive for arbitrage due to the fact that there is a switch to a different capital charge after changing an exposure between the books. Furthermore, a change between the books is subject to very restrictive limitations.

We hold the view that the inclusion of CSRBB under Pillar 1 would not be appropriate.