



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

**EACB Comments
on the Consultative Document of the Basel Committee
on Banking Supervision**

Interest rate risk in the banking book

Brussels, 9th September 2015

The voice of 4.200 local and retail banks, 78 million members, 205 million customers

EACB AISBL – Secretariat • Rue de l'Industrie 26-38 • B-1040 Brussels
Tel: (+32 2) 230 11 24 • Fax (+32 2) 230 06 49 • Enterprise 0896.081.149 • lobbying register 4172526951-19
www.eacb.coop • e-mail : secretariat@eacb.coop



Contact:

For further information or questions on this paper, please contact:

- Mr. Volker Heegemann, Head of Department (v.heegemann@eacb.coop)
- Mr. Marco Mancino, Adviser, Banking Regulation (m.mancino@eacb.coop)

The **European Association of Co-operative Banks** (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 31 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the co-operative banks' business model. With 4.200 locally operating banks and 68.000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 205 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 78 million members and 860.000 employees and have a total average market share of about 20%.

For further details, please visit www.eacb.coop



Key messages

In general, given different bank's business models, portfolio structures and depositors' behaviours and characteristics we believe it is not advisable to specify a globally uniform standardized Pillar I approach for interest rate risk. Under a Pillar II approach institutions' risk managements should be allowed to use their individual models in the most sensitive and appropriate way. A standardised Pillar I 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.

Additional capital requirements under Pillar I are not necessary since IRR is already among the main components of the ICAAP. Moreover, an inappropriate capital charge and standardisation will potentially have unintended consequences on the loan supply to the economy, on market and risk management practices, for instance reducing competition and increasing systemic risk due to less diversified risk management practices, and on the nature of business models for instance forcing institutions to look for alternative longer term funding sources due to constraints on NMDs modelling, or reducing the diversification of products offered to customers. With regard to the loan supply, this might be put under stress due to insufficient sensitivity of the model and a computed risk level that is too high. The resulting capital charge – in combination with all the other requirements – will reduce ability to grant loans, or lead to a surge of offered interest rate on loans. As the computed risk level is too high, this might lead to an inappropriate risk reduction. In addition, as NMDs are modelled too short, they cannot hedge long-term fixed rate loans. Banks might thus reduce long-term fixed rate loans.

We would thus support a properly designed Pillar II approach, able to reflect the diversity and the risk sensitivity of institutions' estimations, rather than Pillar I approach. In particular, behavioural features can only be properly addressed under a Pillar II approach. Such a Pillar II framework should be designed without imposing automatic add-ons or reference to a fall-back calculation methodology stemming from Pillar I. The boundary between a Pillar I and a Pillar II approach should remain distinctively marked. In addition, a Pillar II methodology sufficiently simple to be implemented by smaller banks should be provided; at the same time it should be flexible with respect to key elements such as the modelling of NMDs.

Also the treatment of embedded options is an element on which the paper should provide more clarity (e.g. prepayment features, implicit floors and margins). The treatment of implicit options is especially relevant in the current low interest rate scenario, as variable active and passive products behave differently with negative indicators, depending on legal and technical circumstances.

While interest rate risk is relevant for all institutions, the Committee proposed framework has been designed keeping in mind in particular large internationally active banks. However, the proposed treatment of IRRBB is likely to be rolled out on to a much broader range of institutions including risk adverse and less sophisticate ones. In this respect there is no guidance on how such a complex framework for IRRBB could be efficiently and



effectively implemented and managed also in smaller institutions, thus we believe that the proposals should be reviewed in light of the proportionality principle. In this respect, only a Pillar II approach would allow a sufficient degree of flexibility. A standardised Pillar I approach would increase pressure towards reduced diversification of products and ultimately of competition. Thus, we reject a Pillar I approach.

General Comments

The members of the EACB welcome the opportunity to comment on the BCBS proposals for the treatment of interest rate risk in the banking book (IRRBB).

An excessive push for reducing risk-taking by the banking sector could lead to an increased role of the so-called unregulated shadow banking, which might unduly amplify systemic risk. In order to ensure a level playing field between banking sector and other financial sectors, it is important to balance the sound supervision and sound risk taking by the banking sector without imposing excessively prescriptive regulations.

Moreover, the loan supply would be put under pressure since resulting capital charges will be inappropriately high, and risk management practices may no longer be appropriate, leading to the conclusion of wrong "hedging" transactions. Risk management practices will be instead bound and driven by the desired results of the model and will be no longer connected with the behaviour of customers. This may lead institutions to take positions based on the results of the model while knowing that these do not reflect the conditions of the reference market.

It should also be taken into account that competition is in danger when product calculation is homogenized (a simple "variety of models" for internal calculation does not work, which one gives the steering impulse? How can different risk levels according to different models be explained to the management/board of directors?).

Also the approaches of supervisors in different jurisdictions to questions such as the consideration of own funds, cannot be reduced to a single and simplified Pillar I approach, insensitive to supervisory dialogue and supervisory qualitative considerations.

The proposed standardised models are also not fit for banks with a loyal customer base, such as the clientele of cooperative banks, which includes Members that have long lasting and strong ties with the institution.

In fact, the proposed methodologies (especially treatment for NMDs) are excessively conservative and standardized. We understand the importance of a common measure to some extent but simultaneously we're concerned that the proposed methodologies may not reflect the peculiarity of each country and individual bank, which would result in greater difference between the banks' practice and regulatory standardized measure. Hence, we support a Pillar II approach, leaving national supervisors the discretion to recognize a dedicated treatment for IRRBB.

Overall the proposed standardised approach is also not fit for small and less complex institutions, with simple credit activities, which will be unduly burdened by a demanding implementation process away from their risk management needs.



Risk management practices should vary across banks to best reflect the peculiarity of each country and individual bank. Regulators would need to be able to revise and adapt a Pillar I framework swiftly, while a Pillar II approach would ensure that institutions and supervisors maintain a constant dialogue on the treatment of IRRBB. Moreover a standardised approach may lead to a greater systemic risk.

A Pillar I approach would be suboptimal as it would not be able to capture the peculiarities of each country and individual bank, which allow to effectively run business without impacting lending activities capacity and processes. In addition, a uniform approach may disincentive banks from enhancing the risk management practice.

Regional banks play an important role transforming short-term deposits into long-term loans for the regional economy including retail individuals. This is inherently very different from the trading activities by international bulge brackets. Also, considering that the chance of regulatory arbitrage will be very limited due to the upcoming implementation of the revised boundaries in the Fundamental Review of Trading Book (FRTB), the original intent to introduce a Pillar I approach for IRRBB to reduce regulatory arbitrage) may not be legitimate any more.

A Pillar II approach is better suited to address IRRBB

We appreciate that the Committee welcomes comments on a proposal for Pillar I and Pillar II treatments of IRRBB. We believe that there are strong elements in support of a Pillar II approach. This is reflected in the wide range of methods used in the banking industry for measuring and managing interest rate risk, which has well-grounded reasons:

- The management of interest rate risk is one of the banks' core competences and one of the main strategic variables (e.g. the management of NMDs) in the banking business. Hence, a standardised approach would lead to more uniform business-models and consequently would reduce competition.
- For positions where interest rates are locked in for an indefinite period of time (NMDs), 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 growing importance of supervisory ratios for an assessment of the interest rate risk might create clear incentives for an alignment of the risk management (and, by default, the customer product policy) with supervisory requirements. Banks would no longer be able to provide savings products suitable for the special needs of customers or to provide savings products that are largely unattached to the interest rate level. Consequently also the loan supply might be reduced significantly, since NMDs serve as a natural hedge for long-term loans with a fixed interest rate.
- Only under Pillar II, moreover, a comprehensive view of the overall risk management for interest rate risk can be performed, for instance also in light of credit processes, associated credit risk and banks' practices.
- Each bank has a different risk appetite and this difference is the very reason that allows market transaction to be finalised even under stressed conditions. If the same



loss cut rules were imposed due to the standardized approach, every bank would behave in the same way at the same time, resulting in higher pro-cyclicality and causing severe market disruption. As a result, volatility in the market would be amplified and unregulated shadow banking sector would increase its market presence while providing riskier arbitrage opportunities, which would lead the financial system to an overall unsound situation.

A further element pointing in the direction of a Pillar II approach is the different approach followed by supervisors with regard to the use of own funds in the calculation of overall interest risk exposure to better reflect market specificities.

Moreover, given the regulatory overhaul already carried out the possibility of regulatory arbitrage across the banking book/trading book boundary is extremely unlikely. In addition for numerous cooperative banks, this possibility is not even practical due to the nature of the products held in the banking book and the trading book respectively. In some cases, there are even institutions that only have positions in the banking book due to their business model. By definition, only the banking book contains NMDs. This supports the request for a high degree of freedom concerning the modelling of NMDs.

Finally, providing smaller banks with a simplified and flexible Pillar II methodology should be considered by the regulator. Even the simplified proposal still holds excessive complexity and does not allow the necessary flexibility regarding the most important items, e.g. modelling of NMDs.

The proposed Pillar II approach retains difficulties

While we appreciate the importance attached to the Pillar II approach, we believe that the public disclosure requirements on the risk measurement (e.g. on key assumptions and various model outcomes, behavioural assumptions and hedging strategies) is unnecessary and should be deleted from the proposed Principle 8, otherwise banks will have to argue that those information are sensitive or confidential (as laid out in the CRR/CRDIV and in the Basel Accord). Also the disclosures requested in Table 15 should be removed. Regulatory requirements under the standardised measurement, reporting, and disclosure should be eliminated from the Pillar 2 context as the proposal would reveal too prescriptive and unable to reflect properly each institution's risk profile, thus reducing the effectiveness of a Pillar II approach.

In particular:

- The required ability of banks to test their key behavioural assumptions against the fallback standardised approach (principle 5) is disproportionate. Concerning their internal models, banks have many years of experience and conduct a comprehensive backtesting on a regular basis.
- There is no need for a variety of systems to measure the IRRBB exposures under both the EV and Earnings-at-Risk approach within one bank (principle 6). Two different approaches – one based on EV, one on earnings – are fully sufficient as long as they are well tailored on the institution specific situation.



Under a Pillar II approach, restrictions by regulators to national discretions/calibration should be minimum (particularly, caps on the core deposits maximum maturity and TIA should not be applied in Pillar II). The unique stable deposits features in institutional networks of cooperative banks, which are based on national law or regulation, should be modelled with sufficient sensitivity and flexibility for interest risk measurement purposes, leaving national supervisors the discretion/calibration to recognize a dedicated treatment for such deposits. Alternatively, a dedicated treatment for such deposits could be stipulated as in LCR or NSFR.

Also, the systems of liquidity management in place in cooperative groups and networks (e.g. in EU Member States, such as Germany or France but also in jurisdictions such as Japan) should be adequately considered. A central institution is responsible for ensuring the liquidity of the group/network. Local banks deposit their excess liquidity at their central institution which will allocate it, when needed, to the banks of the group and is also responsible for placing excess liquidity on the capital markets and to take up liquidity on the market when required. In this context, these important deposit volumes show a stable interest rate in connection with the behavioural features of the banks in the network. The stability of these deposits is recognised also with reduced outflow rates in the context of the BCBS LCR framework, similarly banks should be allowed to appropriately model the actual interest rate risk related to these positions.

Wherever possible, a convergence between banks' internal approaches and supervisory approaches should be sought: this will keep the additional costs for parallel measurement processes as low as possible and, more importantly, minimise misguided incentives in the risk management area. In some jurisdictions, it has been practical experience that supervisors demand interest rate risk models fitted as tight as possible to the banks' business models. Thus, the supervisory approaches should provide sufficient leeway for each institution to establish appropriate methodologies as part of the supervisory dialogue. Instead, we fear that the current proposal on the Pillar II approach takes the opposite direction.

We would support a standalone Pillar II framework but not as a Pillar II framework that would operate in conjunction with a Pillar I fall-back methodology. In this regard, under the Pillar II approach, it is important that the standardised framework calculation shall not have to serve as a fall back for assessing the banks' capital levels. Moreover, this is a further element against any mandatory standardised disclosure under Pillar II, which could instead generate unclear information for investors.

Finally, the requirements of the proposed enhanced Pillar II approach on risk governance, technical approaches, disclosure and IT system would reveal unduly burdensome for smaller banks. In order to avoid that this new regulation falls disproportionately on smaller banks the proportionality principle has to be considered of the utmost importance, especially if regulation is aimed at maximising harmonization.



Design complexity of the Pillar I proposal

Overall the approach retained for the Pillar I approach – which seems to be intended as a standard approach – is much more complex and less intuitive than the one retained for other types of risks covered under the Pillar I umbrella (e.g. credit risk, operational risk). In the proposal, the Pillar I is already based on interest rate shock scenarios whereas for other types of risk, the Pillar I is still based on normal business based conditions, leaving shock scenarios to be addressed under Pillar II. The fact that several interest rate scenarios are being considered under Pillar I could create difficulties in performing reliable forecasts of the risk evolution especially if total maturity risk is very small, as the adverse scenario could change from one month to the other due to the underlying factors (i.e. economic environment, magnitude of the interest rate shocks, time horizon, risk profile). The implementation of an appropriate tool in order to manage the IRRBB would have disproportionate costs and would result in important implementation difficulties.

For purposes of assessment and management of IRBBB risk both the use of NII and EVE based approaches are appropriate, and EVE and NII approaches should be allowed alternatively, according to the institutions' practices and supervisory dialogue. A standardised adoption of both approaches combined, not based on the expertise and the practices developed in concert with the supervisors over time, is likely to result excessively burdensome.

In addition, a standardisation per se is inappropriate. The suggested standardisation is particularly detrimental, indeed already the basic assumptions for both the EVE and the NII approach (e.g. caps for modelling NMDs) are not suitable.

We are seriously concerned by capital charges that lack risk sensitivity, compulsory hedging transactions that are inadequate with regard to the underlying risk, increased revenue volatility, and shorter maturities in the lending business (in many countries, there is a strong demand for long-term loans).

Up to now, cooperative banks have rarely faced any extra capital charge due to IRRBB. The proposed model might result in higher amounts of capital charges without any material change in the banks' interest rate risk positions.

If, despite the dangers of reduction of lending capacity and widespread industry recommendations, a Pillar I approach is retained, the complexity of the proposal should be drastically reduced. A complete risk assessment could then be performed under Pillar II.

Finally, while we appreciate that the Committee is no longer pursuing the idea of capital charges for CSRBB within the Pillar I framework, we see that this is now included in the proposed Pillar II approach. Up to now, however some of our Members have reported that the current consideration of CSRBB is very limited (EVE framework, fungible securities featuring a market price), thus there seems to be no need for any additional



consideration for CSRBB. Nevertheless, we would like to ask the Committee to further sharpen the definition of credit spread risk.

We think that the possibility and scope of the using of the internal estimates (e.g. Times Series Approach (TIA) and Simplified TIA (SITA) for the NMD; CPR (Prepayment on fixed rate loans); PTR (Fixed rate loan commitments); TDRR (Term deposits subject to early redemption risk)) in the standardised approach should be better clarified and better addressed. Nevertheless, we stress once more the fact that a Pillar I approach is not an opportune choice.

In particular, the formal supervisory approval requirement under the Pillar II approach should not be required, while it should be provided that supervisors have to be fully aware of the implications of the internal models, and to challenge as appropriate when the outcome is inadequate or not robust. Should a formal supervisory approval be introduced we believe that when a third-party model is used by a network of banks (as is often the case for banks in cooperative networks) the supervisory approval 'process' has to be performed only once and towards the outsourcer.

Selected technical aspects

➤ Design of a supervisory model for capital measurement

One of the key objectives of most commercial banks is to minimise the volatility in future earnings so that the net interest income on the banking-book activities adequately covers the associated operating costs and cost of risks and allows for stable returns on equity.

If a static analysis such as the one proposed under the Pillar I enables to properly allocate the net interest income between business units, on the one hand, and treasury, on the other hand, we do not believe that it provides relevant information to external stakeholders. Such a metric indeed lacks suitability as a risk measure as it shortens the analysis to the modelling horizon and does not take into account a possible interest-rate risk exposure beyond that horizon. More specifically, it does not take into account a bank's exposure on the liability side with low pass-through rates due to its regulatory or competitive environments and its actual ability to adequately cover its fixed costs on a long-term basis.

We see that both approaches, i.e. EVE and NII should be equally available as an alternative method to one another, given permission of the supervisor. Given that the NII and EVE approaches do not necessarily yield identical results in different interest rate scenarios, we hold the view that a supervisory capital charge based on both methods would be counterproductive.

One of the key advantages offered by Net Interest Income approaches consists in the dynamic simulation of portfolios. The discussed static supervisory approach, however, does not deliver sufficiently meaningful results, since it is not consistent with the banks' earnings plans. Moreover, the proposed approach assumes the full reinvestment of the net repricing cash flows at the shocked interest-rates until the end of the analysis period.



This implies e.g. an immediate repricing of all non-core demand deposits and therefore contrasts with the actual observed slow repricing. In particular, demand deposits are characterised by interest-rates near zero, hence independent from the levels of the respective market interest-rates. The highest margins are consequently earned when the general level of interest-rates is high.

We understand the reluctance of regulators to fully base capital requirements on an earnings approach due to the difficulty to determine assumptions on a long-term basis for the new credit activities and that such analyses may miss the long-term transformation position.

Given that the NII and EVE approaches do not necessarily yield identical results in different interest rate scenarios, we still hold the view that a supervisory capital charge based on a rigid combination of both methods would be counterproductive.

The approach should instead allow institutions to maintain the most appropriate methodologies as designed developed and discussed over time with their supervisors.

Finally, we are of the view that pass-through rates are neither suitable for modelling a bank's repricing policy (it would not be transferable into a trading strategy) nor an appropriate measure to distinguish between stable and less stable deposits (Pillar II, principle 5).

➤ *Outlier test criterion*

Regarding the proposed Principle 12, the fact that supervisors may have a certain % threshold of change of EVE/CET1 (or Tier1) in mind when reviewing the interest rate risk in each financial institution seems reasonable. However, that threshold should not be publicly disclosed in particular because financial institutions have different business models and risk profiles, as well as different tolerance levels to changes in EVE. In addition, management ability of portfolios (i.e. market liquidity to hedge or ability to mitigate interest-rate risk) should be considered as a key aspect of their risk profiles. Therefore, a "one-size fits all" threshold may not be appropriate for supervisors to assess the interest-rate risk profile of various financial institutions.

➤ *Differentiation of interest rate risk's components*

The usefulness of generally applicable high-level rules for basis risk is rather doubtful. The complexity of the proposal in distinguishing the various components of interest rate risk would only produce marginal results for the overall risk management. In addition, for many cooperative banks, the diversity of financial instruments bearing interest rate risk is limited. Even for institutions with more complex and varied range of activities, the introduction of thresholds could be envisaged on the basis of the total risk exposure/number of instruments. Treating the different elements of interest rate risk



separately and under a Pillar I framework is likely to lead to misspecification and incorrect aggregation of results.

Thus, the mandatory separation of the components of interest rate risk (e.g. repricing risk, yield curve risk, basis risk, risk option) is unnecessary. For instance, the business model of cooperative banks focuses on retail banking rather than trading activities. In this case the basis risk, for instance, is negligible, and it should at least be subject to threshold levels. Moreover, in the case of smaller institutions, since this separation implies the implementation of dynamic models, we do believe that the effort and cost of implementing such models will far outweigh the intended benefit in terms of improved identification and measurement of the risk, and overall also the benefit of this breakdown are unclear.

Existing approaches usually do not differentiate among the four components of interest rate risk (repricing risk, yield curve risk, basis risk, option risk). Many banks manage interest rate risks on the basis of the entire bank's cash flow, i.e. these risk components are considered implicitly. The proposed rules should not impose a mandatory separation of the four components of interest rate risk for all banks regarding the assessment and quantification of interest rate risk. A subsequent re-aggregation would lead to unnecessary inaccuracies.

➤ *Multipliers for redemption rates, NMDs, and stability of cooperative banks' customer base*

The proposed multipliers for redemption rates do not account for the unique stability of the cooperative banks' customer business and, as a result, are far too high. In general, national supervisors should have the discretion for a dedicated treatment of the cooperative banks' special characteristics.

A uniform supervisory rule (i) for the clustering of NMDs and (ii) for the assignment of durations will lack an adequate degree of risk differentiation. By using standardized specifications, it is impossible to obtain a classification suitable for every single bank. In particular, the experience shows that NMDs typically show much longer maturities than those envisaged in the Committee's proposal. Constraining the modelling of maturities on NMDs is likely to have impacts also on the practices and the nature of the business model, forcing institutions to change the nature of the relationship with their clients to be able to maintain funding on longer maturities.

- The correct modelling of NMDs is the most important element of the interest rate risk measurement in the banking book. The capacity of a bank to provide an appropriate view of the volume, the investment duration and the interest rate sensitivity of this funding source forms part of its decisive competitive factors. Therefore, banks can usually draw upon many years of experience in the modelling and validation of customers NMDs. There are various approaches for modelling purposes. They all have in common that the respective products are assigned to clusters that – concerning a bank's repricing policy – are as homogeneous as possible. The proposed classification according to customer groups (retail vs. wholesale) and "transactional" vs. "non-



transactional" is inadequate – also in terms of the distinction between repricing and liquidity risk.

- Imposing an average duration of three years and a maximum duration of six years is particularly detrimental. The duration and the fixed interest rate of these deposits are determined by the bank's product policy and reflect the interest rate adjustment. Determining the interest rate adjustment behaviour is part of the corporate strategy and hence, entrepreneurial freedom. The implementation of rigid rules for the supervisory treatment of these exposures would cement a duality between "supervisory" risk and "actual" risk. This will increase the likelihood of any undesirable effects. In an attempt to reduce the regulatory capital charge, corporate decisions – including but not limited to interest rate risk hedges or changes to the terms and conditions offered in order to attract more deposits - are taken on the basis of wrong behavioural assumptions and also lead to P&L distortions.

In addition, the categorisation of deposits as transactional or non-transactional relies exclusively on qualitative criteria and is not clearly defined in the consultation paper. On one side, the retail deposits have to be considered as held in a transactional account when regular transactions are carried out in that account (e.g. salaries are regularly credited) or when the deposit is noninterest bearing. Indeed, the absence of remuneration on a deposit may be an indication that the deposit is not used as a savings account by the depositor and thus can be considered as transactional. On the other side, banks must apply their own criteria based on historical data or local/business model features. We recognise that such approach intends to allow a certain degree of flexibility in the recognition of local practices, but this should be more clearly detailed.

Also, the situation where a borrower is free to make prepayment at any time since they have no economic costs charged (variable rate loan) is not defined and considered. For instance, in certain markets (e.g. Luxembourg) the rate is completely variable, meaning that any new fixing is only based on the economic environment/decision of the bank instead of given fixing periods such as 3 months. In addition the prepayment can take place at any time without additional costs. As it is up to the borrower to exercise the option (behavioural option), the contractual repricing should be adjusted by the management's estimates of prepayment risk.

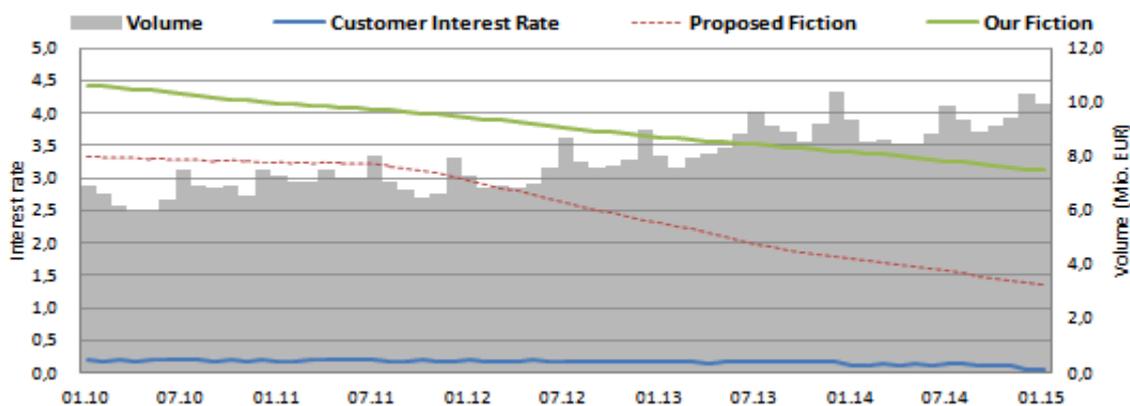
With regard to the time series approach (TIA), stability caps and pass-through floors for NMDs by category or proportion of NMD amounts eligible to core NMDs in the simplified-TIA should only be scaled on the basis of a QIS exercise. The categorisation as well as the parameters should be assessed frequently or an adequate flexibility concerning the modelling should be allowed. Moreover, models, categories and parameters would need to be suitable for every country.

Finally, the proposed implied caps on core NMDs that are not subject to immediate repricing are far too low. Under the simplified Times Series Approach, the portion of 40% "non-core" NMDs even applies for the historically extremely stable demand deposits of retail customers. In conjunction with the maximum average duration of three years for core deposits, the resulting interest rate risk would be completely mis-specified.



See here below for instance the results of the backtesting for one of our Member banks, which clearly indicates and follows the much more stable behaviour of the customer interest rates than the one resulting from the proposed methodology:

BACKTESTING



➤ *Positions with behavioural options other than NMDs*

In the case of a non-retail customer holding products with a behavioural option, it should be taken into account that this may change the pattern of notional repricing cash-flows; such options should be included within the category of automatic interest rate options. We suggest allowing the use, subject to supervisory approval, of internal estimates approaches for these specific positions, like for positions with behavioural options other than NMDs (based on all relevant, material and available data, with information and methods duly documented, reviewed and validated by independent expert).

➤ *Prepayment on fixed loans*

A stress on CPR (Conditional Prepayment Rate) should be applied only during the first year as clients would react within this timeframe in case of a decline in interest rates. Beyond this timeframe, the CPRs would return to their structural level, following the decline in interest rates. In addition, the scaling factor should be applied to the average historical prepayment rate (or the minimum as it is closer to the structural prepayment rate) and not the current estimations used by the bank as these may already have been stressed after a decline in interest rates. As an alternative to standardised scaling factors which are not representative of local specificities, we recommend retaining the minimum prepayment rate observed historically by a bank on the relevant portfolio (for a parallel shock up) or the maximum (for a parallel shock down), these two values could then serve as the lower and upper limit for the remaining factors. The same methodology can be applied to term deposit subject to early redemption risk. In general, a more complex multi-period example of the calculation of prepayment risk would be helpful.

➤ *Treatment of Own Funds*



The proposal seems not to allow the use of own funds in any of the calculation of the interest-rate risk exposure. This is likely to induce undesired consequences as a result of:

- a significant and contrived increase in the interest-rate risk exposure, as own funds are normally assimilated to long-term stable deposits, with a maturity of more than 10 years;
- an incentive to fund business in the interbank market, especially for long-term funding or forcing to increase the maturities of non-maturity deposits determined by a change in the nature of the business, leading to offer different contractual conditions to existing clients (shift towards term deposits).

Those two effects combined could adversely impact the net interest income of institutions, which is yet a key contributor to the increase of their own funds, year after year.

Independently on whether capital requirements against IRRBB should be considered as part of Pillar I or Pillar II, we are of the view that own funds should be considered as a unique long-term funding base. Otherwise, not only the level playing field would not be guaranteed, but the supply of fixed-rate credit, which increases maturity transformation, by banks with sound and consistent own funds basis could be limited in the future, hence possibly affecting the economic growth. If own funds are from now on excluded from the calculation, the regulatory treatment of IRRBB will force many banks to raise long-term funding in the market to reduce their regulatory interest-rate risk exposure, or it may force banks to hedge the risk with Interest Rate swaps which could adversely impact their income and increase CVA.

➤ *Interest shock scenarios*

We welcome plans to link the interest shock scenarios to the interest rate level of the respective currency.

We are of the view that it is not appropriate to provide for shock scenarios that are proportional to the current level of interest-rates, based on a log-normal equivalent model as specified in the consultative document. In the current low interest-rate environment, it would result in a shock equal to the floor (i.e. 100bp). However, in case of an increase in interest-rates, the required shocks would rise and may even reach the maximum of 300bp in case the market interest-rates would normalise. A 100bp (maximum of 300bp) parallel shift may not reflect the reality of normal market condition as central banks only change policy rates gradually and in a careful manner, considering the overall impact of changing interest rate while allowing banks to change the funding structure. Also, 100bp of interest rate shock may be excessive in light of the very low rate environment in some jurisdictions, including the Eurozone and Japan. Such a model would result in particularly volatile capital requirements.

However, it has to be ensured that the resulting yield curve is arbitrage free. Furthermore, the yield curve should not be too unrealistic, e. g. in terms of slope.



Moreover, the handling of negative interest-rates (before the application of the shock scenarios) requires further specification.

Generally speaking, the interest rate regresses toward the mean. In order to reduce the procyclicality, which may result in fire sales of fixed-income instruments, the reference rate to be used as a starting point in the construction of the shock scenarios could be based on an historical average of the observed rate for a given time bucket, or currency-dependent appropriate level determined by each national supervisor rather than the proposed current most recent observed interest rate (i.e. current local risk-free continuously compounded observed rate, see page 56), in analogy for instance with the construction of shock parameters based on time series. In the rapid interest hike scenario, banks would be strongly discouraged to take more interest-rate risk through fixed-income investments or fixed-rate mortgages, which may result in undue effect on the real economy.

The six month holding period is far too long. This is especially true for an overnight interest rate risk simulation. Moreover, the outstanding positions could be hedged within a few days.

➤ *Shortcomings of the proposals for specification of Pillar I capital requirements*

There are four proposals regarding the calculation of minimum capital requirements under the Pillar I approach. The pure EVE measure (option 1) is simple and straightforward. However, it does not consider the potential short-term gains that could offset the EVE loss. This is provided by option 4. However, because the Net Interest Income and the Economic Value approach adopt fundamentally different perspectives, the models need substantial testing and an evaluation of their results.

With regard to the aggregation parameter for different currencies, where "w" is defined as the parameter for recognizing a partial offsetting (see para. 5.1), based on the long-term historical data, a symmetric correlation parameter such as 0.7 would be more reasonable and realistic. Also, the aggregation methodology should be consistent (i.e. not asymmetric) between the one offsetting the profit and loss (where "w" is set preliminarily at 0.25) and the one aggregating the losses (where "w" is 1).

Timetable for the implementation of a new framework

It seems clear that given the IT developments required and the needed time to undertake commercial actions to extend the duration of deposits (long-term funding), based on market conditions, a very reduced timeframe is provided. We believe that the new framework should not enter into force at least before the envisaged timeline for the fundamental review of the trading book (i.e. 1st January 2018). In this respect, the newly issued EBA's guidelines states that "*Any outcome of BCBS working group will not be fully implemented before 2019*". However, given that the new EBA's guidelines will take effect from 1st January 2016, it is important that changes in the regulatory framework are well coordinated. The Committee should also take into account other ongoing reforms such as



the IASB project on macro-hedging, in order to allow to the degree possible an alignment between the prudential and the accounting perspective.

We also recommend providing for a transitional period to allow for banks which will face important changes in their activities profile (e.g. inability to consider own funds in their cash-flows) to be compliant without effects on their profitability.