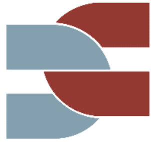

EACB Comments

EBA draft GL on on the management of interest rate risk arising from non-trading book activities

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General comments

The members of the EACB welcome the opportunity to comment on the EBA draft GL on the management of interest rate risk arising from non-trading book activities (interest rate risk in the trading book, IRRBB).

While in principle we appreciate the idea to align the IRRBB framework to the recent regulatory developments we do not believe that the moment is appropriate. In fact, IRRBB constitutes a crucial component of the ongoing Review of the CRD/CRR, where numerous both high level and technical questions are on the table. It would be more efficient to postpone the new GL until the legislative process is concluded to avoid any misalignments and consequent recalibration of the GL. This would avoid unjustified additional implementation burden for institutions.

Moreover, we would also point out that overall the draft GL do not sufficiently address proportionality. A proportionate approach should not only lead to reduced reporting obligations, but should also foresee that only calculations that are needed for and justified by the business model and risk profile of the bank are performed. Also the systems and processes put in place should reflect the nature of the institution's business and should only cover the relevant material risks for the institutions in question.

Answers to specific questions

Q.1 Are the definitions sufficiently clear? If not, please provide concrete suggestions and justify your answer.

In terms of general concepts, the definitions of CSRBB is not clear enough. It is in fact only stated that CSRBB is spread risk of interest rate sensitive instruments other than IRRBB or credit risk.

In general CSRBB should not be part of the IRRBB GL but rather a different risk class. There are various ways to correctly model CSRBB, and institutions may analyse it separately from IRRBB or may model the two risk types together.

Overall, we believe that the newly added definition of CSRBB in the IRRBB guidelines goes too far. Even if the requirements for CSRBB are still indicated very vaguely in the draft GL, it cannot be excluded that further and stricter detail would follow in following updates.

Thus, it should be ensured that at least the definition is appropriate. We see a risk in the more sweeping definition that e.g. full fair value measurements of loans will have to be included in EVE, or that margin risk from loans will fall under the definition of CSRBB for NII. In terms of substance, it would, for example, be appropriate to include CSRBB in EVE only if it results from exposures (especially securities) that are measured at fair value. Spread effects from securities should only be relevant (if at all) in NII in the context of IRRBB if the securities were acquired for purposes of interest rate management (i.e. normally securities held by treasury).

Q.2 Are the guidelines in section 4.1. regarding the general provisions sufficiently clear? If not, please provide concrete suggestions.

The modelling of NPE requires significant data analysis and the need to make a number of assumptions. This could reveal burdensome and time consuming in particular for those institutions that have portfolios with a low probability of default.

As already indicated in Q1, we would like to stress that CSRBB should rather be considered as a separate risk class whose definition should not be mixed together with interest rate risk. If addressing CSRBB in a separate regulatory product is not possible, the distinction between IRRBB and CSRBB should at least be clearly indicated in the GL.

Q.3 Do you agree that cash flows from non-performing exposures (NPEs) should be net of provisions and treated as general interest rate sensitive instruments whose modelling should reflect expected cash flows and their timing for the purpose of EV and earnings measures? If not, please provide concrete suggestions and justify your answer.

In general, while provisions should be reflected in risk measurement and management., there are various methods for including provisions. Provisions are made as a forward-looking prudential measure, and in principle the amount due by the customer to the bank remains the gross amount.

We thus believe that there should be no standard requirements about when and where provisions should be included; rather, they must be included to reflect the individual institution's management. The approach adopted should be reported to the supervisor so that an appropriate assessment can be performed on the reported figures for the calculated change in EVE in an interest rate shock.

If the credit loss has already occurred and there is no longer any contractual claim for payment of interest, the entire defaulted interest-related transaction is no longer part of the total cash flow. The default risk of troubled interest rate products is measured and managed in counterparty risk.

In addition, regardless of when and where provisions are included, there should be also no hard-and-fast rule for the amount to be recognised. There may not be any one-to-one recognition of accounting carrying amounts in order to avoid mixing business management and accounting rules. The cash flows expected by the bank must be recognised regardless of the amounts actually written down

A clarification is also needed with regard to whether the GL refer to specific provisions only, or whether general provisions are being considered as well. General provisions would be difficult to allocate at a single exposure level within the IRRBB system.

Finally, for operational reasons we would like to propose that modelling of cash flows from NPLs should only be required when material and according to the proportionality principle.

Q.4 Are the guidelines in section 4.2. regarding the capital identification, calculation, and allocation sufficiently clear? If not, please provide concrete suggestions and justify your answer.

With regard to capital identification, calculation and allocation, at least on para. 26(f) more clarity is needed on the definition of embedded losses.

Also para. 56(g) should be better specified. It would be beneficial to know which degree of flexibility institutions can expect for their IT systems, as IT costs can quickly escalate.

Q.5 Do you agree with the list of elements to be considered for the internal capital allocation

in respect of IRRBB to earnings in paragraph 30? If not, please provide concrete suggestions and justify your answer.

Q.6 Are the guidelines in section 4.3. regarding the governance sufficiently clear? If not, please provide concrete suggestions and justify your answer.

With regard to para. 41, a bank's management body should not be seen as directly responsible for decisions that can often only be made in day-to-day business operations. A good example is paragraph 41(c), because major hedging initiatives are developed and decided in the course of day-to-day business operations. It is neither practicable to define a suitable framework for this in advance, nor is it possible to involve the management body in these decisions in a timely manner.

As a general consideration on IT system and data quality, we would stress the requirements for IT systems should not be identical for all institutions, but should only cover the relevant material risks for the institutions in question. For example, basis risk is usually not relevant for many small banks, it would have no supervisory benefit a general obligation for all IT systems to be capable of modelling it. This should be adequately addressed in the Guidelines.

Also, we believe that the in-depth requirements for internal reporting are too detailed and far-reaching. At a fundamental level, we wish to refer to BCBS 239, where the reporting obligations are already addressed, and the underpinning element is that the level of detail decreases as the hierarchy increases. This concept is not at all reflected in paragraph 67, for example. We rather see a booming of the reports become with a loss of informative value (i.e. regular reports to the management body that cannot be used to generate any management triggers). Because of the complexity of the overall topic of IRRBB and the different business models, the institutions should have more room to decide the form in which a breakdown of risks for the management body makes sense. The existing requirements in the Guidelines governing internal reporting were entirely adequate.

Q.7 Are the guidelines in section 4.4. regarding the measurement sufficiently clear? If not, please provide concrete suggestions and justify your answer.

Q.8 Do you consider the comparison between EV metrics calculated using contractual terms for NMDs with the EV metrics calculated with behavioural modelled assumptions sensible and practical? Please justify your answer.

The behavioral assumptions made by institutions in modelling NMDs are subject to appropriate governance to ensure the assumptions are sensible and a fair reflection of the economic reality.

We do not believe, on the other hand, that the approach proposed in the GL is practical. There is no connection between the contractual terms and the behavioural assumptions for variable products. Calculating EV metrics using contractual terms for NMDs does not reflect the economic reality and will add unnecessary reporting burden.

Whereas contractual terms are an unrealistic case of a right that theoretically applies to all customers, the behavioural assumptions primarily involve modelling repricing using a trade executed on the money and capital market as precisely as possible. On the one hand, the margin remains a variable that is as constant as possible. On the other, interest rate risk from this product is optimally eliminated.

A comparison of both variables (contractual term and model) is thus not necessary, nor does it lead to any understanding in terms of interest rate risk. In light of the overall expected additional effort, all unnecessary calculations should be avoided.

Q.9 Are the guidelines in section 4.5. regarding the supervisory outlier test sufficiently clear? If not, please provide concrete suggestions and justify your answer.

With regard to the supervisory outlier test (SOT) we appreciate that para. 21 provides that the new threshold of 15% of Tier 1 will only apply to SREP category 3 and 4 institutions 6 months after the guidelines enter into force, allowing for a timely preparation for the calculation of the new outlier test and providing the smaller institutions with a longer phase-in period.

We also appreciate the references in para. 25 and 83 to the fact that institutions should not only rely on the supervisory assessments of capital adequacy for IRRBB or on the outcome of the supervisory outlier test but should develop and use their own methodologies for capital allocation, based on their risk appetite, level of risk, and risk management policies.

It is extremely important that there is no automatic mechanism between the result of the outlier test and possible supervisory measures. IRRBB must always remain an idiosyncratic process.

Specific clarifications and amendments

It should be clarified whether para. 113(c) mean Tier 2 capital instruments can be included in the calculation of the Standard EVE outlier test.

Two of the scenarios set out in Annex III refer to parallel +/- 200 basis points shift of the yield curve similar to the tests defined in para. 111. However, the regulatory limit in para. 111 is set at 20% of own funds while the threshold in para. 112 is set at 15% of Tier 1 capital. An institution with significant subordinated debt (Tier II) could reach the 15% of Tier 1 threshold while being comfortably within the regulatory limit. The 15% of Tier 1 threshold is therefore not a relevant "early warning signal". We believe both limits should be based off the same capital measure for clarity (own funds).

More in general, the SOT systematically puts at a disadvantage institutions that built consistent positions in their interest rate book as a result of prudent and stable investment policies. As a rule, these assets do not lead to a 1:1 increase in capital. The higher the hidden reserves generated by the investments, the greater the interest rate coefficient will be. This means that particularly stable banks (with a high net asset value) are especially impacted. As a result, the outlier criterion cannot serve as an objective measure for assessing IRRBB in a cross country comparison. This test itself does not become more meaningful if the numerator is based on six scenarios that represent extreme stress cases and the denominator is still an accounting measure (whether own funds or Tier 1 capital).

In light of this, it is of the utmost importance that no automatic mechanism is based on the SOT from which to derive mechanically own funds requirements.

We would also reiterate that the SOTs requirements anticipate the ongoing legislative process whose final outcome is yet to be clear. Finally, we are therefore not in favour of the coexistence of two prudential indicators.

More in detail we do not support the following elements:

Paragraph 113(d): The requirement for behavioural assumptions that depend on the interest rate scenario is not appropriate. Behavioural assumptions are independent (or at least can be) of interest rates. As an example, especially for the overnight shock modelled for the SOT, there cannot be any change in behaviour. Even if there were a slight dependence on interest rates, a direct change in behaviour would be extremely unrealistic.

Paragraph 113(f): it is unclear what is meant by "repricing". Principal is automatically remeasured when the interest rate risk cash flow is remeasured at overall bank level following the simulated interest rate shock. After all, this is precisely the idea behind determining a change in EVE.

Paragraph 113(n): we would welcome a situation where not only discounting using a risk-free yield curve per currency were to be permitted, but also discounting using several yield curves per currency. We believe that it is appropriate for institutions to be able to use the yield curves they use for their internal management for the SOT as well. We wish to draw attention to the future disclosure requirements at this point. It will be difficult to explain the differences between internal and external calculations resulting from this requirement.

Paragraph 113(o): the five-year cap for NMDs required for the EU represents unnecessary gold plating when compared to the Basel requirements. We strongly oppose this requirement. Moreover, the stricter requirement excluding financial institutions from behavioural deposits is based on the assumption that financial institutions always act as perfect economic agents. However, reality has shown that this is not the case. Insurers and pension funds in particular do not always make their investment decisions merely on the basis of interest rate changes. We do not support this assumption. In addition, we would appreciate a clarification on the cap as our understanding is that the cap will be calculated as a volume-weighted average for all liabilities.

Finally, we would stress that the information contained in the numerator of the SOTs can only be comparable if there are no standardised requirements for modelling NMDs. Overly restrictive requirements produce meaningless results, especially in the case of interest rate risk (diversity of business models, heterogeneous customer behaviour in Europe due to cultural and legal factors).

Q.10 Is the proportionality adequately reflected in the guidelines, in particular in relation to the transitional period for SREP category 3 and 4 institutions and the frequency of calculation for the additional outlier test under paragraph 112?

We believe that proportionality has not been sufficiently taken into account. For instance, the frequency of calculation for the additional outlier test for SREP category 3 and 4 institutions is similar to the frequency for category 1 and 2 institutions, not reflecting proportionality in this respect.

Moreover, a proportionate approach should not only lead to a marginal relief due to reduced reporting obligations, but should also encompass wider qualitative and quantitative aspects in terms of required calculations and efforts. A single meaningful economic indicator such as value at risk (measured as the deviation from the expected value) could be a much more significant metrics for small institutions and also adequate if compared to various

indicators or measures that do not in the aggregate have any relevance for management. All in all, we would flag as overly complex elements such as the disaggregation of spreads, the inclusion of interest payment as well as principal cashflows, and the use of multiple interest rate floors across the yield curve. We also see that NPLs and pension items could be dealt with more simply.

Q.11 If relevant, do you manage interest rate risk arising from pension obligations and pension plans assets within the IRRBB framework or do you cover it within another risk category (e.g. within market risk separately from IRRBB, etc.)?

Q.12 Which treatment of commercial margins cash flows do you consider conceptually most correct in EV metric, when discounting with risk free rate curve: a) including commercial margins cash flows or b) excluding commercial margins cash flows? Please justify your answer.

The answer cannot be unequivocal as institutions adopt both approaches. In general, this should not impact the way the institutions manage IRRBB.

Q.13 Are your internal systems flexible enough to exclude margins for the purpose of calculating EV measures for the supervisory outlier test? If not, what would be the cost to adapt your systems (high, medium, low)? Please elaborate your answer.

Q.14 Do you consider the level of the proposed linear lower bound as described in paragraph 113 (k) appropriate? If not, please provide concrete suggestions and justify your answer.

With regard to para. 113(k), we see as highly questionable the added value of having a maturity-dependent interest rate floor compared to the effort required to implement it. Institutions do not yet offer (nominal) negative interest rates to clients.

Q.15 Do you consider the minimum threshold for material currencies included into the supervisory outlier test (5% for individual currency and minimum 90% of the total non-trading book assets or liabilities) sufficient to measure IRRBB in term of EVE? If not, please provide concrete suggestions and justify your answer.

Q.16 When aggregating changes to EVE in the supervisory outlier test, does the disregarding of positive changes to EVE have a material impact on the calculation of the supervisory outlier test?

With regard to para. 113(m) we see that the proposed approach is not adequately considering the interactions between currencies and interest rates. Merely showing negative EVE changes is arbitrary and extremely conservative. It does not reflect the banks' risk position and negatively affects banks whose FX funding is fully hedged by FX derivatives. The objective should be a scenario-specific analysis. We suggest to amend in this sense the paragraph.