



BANKING STAKEHOLDER GROUP

EBA CP 2017 19
CONSULTATION PAPER ON GUIDELINES ON TECHNICAL ASPECTS OF THE
MANAGEMENT OF INTEREST RATE RISK

COMMENTS

BY THE EBA BANKING STAKEHOLDER GROUP

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Subject matter, scope and definitions

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

We suggest that further clarification of the following definitions would be helpful:

Constant balance sheet

Products will not always be replaced on a precisely like-for-like basis. This risks a disconnect between regulatory prescribed stress tests and a bank's actual measurement of interest rate risk. The cash flow re-invested on maturity is not likely to be re-invested at the original product margin.

Dynamic balance sheet

There are different degrees of dynamic modelling, encompassing different details of future business expectations, for instance new volumes of business and prepayments. The depth of modelling required should be proportionate to the impact of the particular metric and to the size of the institution.

Option risk

Does the EBA expect that embedded behavioural option risk includes, for instance, non-retail implicit options such as loan commitments which may not always be exercised automatically. How should these be treated?

Credit spread risk from non-trading book activities

Credit spread risk from non-trading book (CSRBB) should be restricted to liquid banking book instruments. The EBA definition appears to cover any instrument in the banking book, therefore including products margins. In our view it should only consider those accounted for as fair value which, in our view, would include a market credit spread.

General provisions

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

There are legitimate reasons for taking interest rate risk in the banking book, for instance the existence of structural positions that cannot be easily hedged, operational time lags or expected offsetting customer flows. And there is less legitimate IRRBB position taking, in expectation, for instance, of future interest rate changes. That this is inappropriate should be explicitly identified as such in section 4.1.

Paragraph 14 appears to require instruments that are fair valued through OCI to be stressed.

Question 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.

We agree although banks should also take into account the behaviour of assets once an impairment has been recognised. It may be that such net exposures should be better regarded as a fixed, rather than variable rate asset, but subject to modification based on the bank's actual approach.

Question 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.

To avoid differential interpretation of the Guidelines by different competent authorities we suggest more elaboration on some of these factors would be welcome, including:

- How should banks assess the 'effectiveness' (para 26 b) of hedging open positions? This may be difficult for capital assessment purposes, although we recognise that banks undertake this for performance assessment purposes.
- Recognition that embedded gains, (para 26 f) as well as embedded losses, should be taken into account and that these can be netted off when they arise symmetrically in the event of a stress.
- In the view of some members, the variability of income is not a risk against which should hold capital. In their view this risk should be addressed in stress testing. Other members have the opposite view, to the extent that variability of income implies risk.
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We note that there is difficulty in meaningfully combining both EVE and earnings approaches and more guidance on this would also be helpful - it is not just a matter of eliminating double counting.

Question 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.

We welcome the explicit recognition that banks should model IRRBB capital requirements using their internal models and own risk appetite and agree that the capital adequacy assessments should take in to account a variety of factors.

As we note above some members have difficulties in understanding why capital should be held against earnings variability which can arise for a number of reasons, as a result of

- variability that may occur beyond the earnings measure time horizon
- impact on earnings at the point of non-viability, for instance the cost of unwinding hedges
- the possibility of supervisory intervention if the bank is believed to be running a deliberately unhedged open position.

In their view, these may or may not be reasons for banks to hold extra capital but further discussion on this would help to ensure a common approach to capital held against EV risk arising from rate shocks. As banking book positions are normally held to maturity it is their view that the resultant variability in income will not be realised.

Other members disagree with this view and think that variability of income should result in higher capital requirements. In particular, they think that supervisory intervention is always too little too late.

Governance

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

We are supportive of the governance guidelines. They are helpful and represent existing good practice among banks.

We note that para 42 b requires, quite properly, the separation of risk managers and risk takers. But question whether the term 'risk taker' is appropriate, reminding us as it does of trading book activities. In the banking book IRRBB originates from customer exposures which is then passed to the ALM function for management. A better term would be 'risk mitigation' functions which would also emphasise that taking proprietary positions in the banking book is not appropriate.

Measurement

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

We support the Guidelines' recognition that banks should use a range of quantitative tools and models.

But the focus, (in para 106 a) on the behaviour of current accounts at the individual level is inappropriate. In our view, what matters is the total aggregate balance and how this might change in the event of a stress. Individual account analysis may, in our view, result in an overly prudent, under estimation of core balances.

We note that the stabilisation of earnings arising from a bank's own equity (in para 108) suggests that banks should avoid reducing their capacity to adjust to significant changes and understand the trade-off (between stabilising earnings and an opportunity loss) that putting on a hedge crystallises. It would be helpful to understand what such changes might be - our assumption is that the EBA is highlighting the possibility of equity decrease at the point of non-viability.

Question 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 risk indicators calculated using contractual terms do not show an adequate result of the current risk exposure of a bank.

Nevertheless, the comparison of EVE metrics using contractual terms and behavioural models may be used to estimate the impact of the IRRBB models applied by each entity, but when this effect is low, it cannot be concluded that the impact of the models is immaterial. Thus, this metric is inappropriate to compare the model risk among banks (sensitivity assumptions should be used instead).

Supervisory outlier test

Question 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.

We note that the Guidelines require banks to calculate two Standard Outlier Tests (SOT). Our expectation is that the EBA Guidelines will be re-issued to reflect the Basel 2019 SOT in due course.

We support the use of the SOT as a tool to assist supervisors as they undertake peer group analysis. Our assumption is that there will be no automatic supervisory response if a particular bank exceeds the 15% threshold, which can often be explained by decisions about equity hedging rather than responses to market developments. Confirmation of this as a permanent, rather than interim approach would be appreciated.

Question 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 support the inclusion of proportionality and recognition that smaller banks may calculate and report SOT results less frequently than larger ones. Further guidance on what constitutes 'small trading book business' (para 113 b, would be appreciated.

Our assumption is that the Guidelines apply at consolidated level and not at solo and sub-consolidated levels. Confirmation of this would be welcomed.

Question 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.)?

Individual institutions to respond on pension issues

Question 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.

Different banks will approach this question in different ways. We believe that the treatment of commercial margins should be coherent with the internal IRRBB management practices. Our reading of the draft Guidelines is that the use of a risk free rate is expected

Question 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.

Some banks may be able to accommodate the exclusion of margins others may find this more problematic and would incur significant costs in adapting to this element of the SOT.

Question 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.

We understand and agree on the conceptual underpinning of phasing out the floor over a period of 30 years but understand this may be subject to IT constraints for some banks. As the floor phase out is relatively modest we would appreciate the Guidelines giving consideration to continuing to use a

parallel floor for a period of time, for those banks where the impact of downward scenarios is not significant.

Question 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.

A minimum currency materiality threshold of 5% and a coverage requirement of 90% of the banking book seems reasonable. Some members suggest that where there is an aggregated exposure in excess of 10% but this is spread over more than say 5 different currencies an exception to this requirement should be made. Other members do not agree with this view.

Question 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?

The size of the impact will depend on the risk profile of each entity, but it will presumably be material for banks with operations in several currencies.

The aggregation methodology proposed for the Outlier Test is extremely conservative and methodologically wrong. We consider this proposal incorrect, as it fails to capture the well-known risk diversification effects among different currencies and, moreover, ignores any compensation between gains and losses. We deem that any method introduced, should take into account the correlation effects, and recognize the benefits in terms of risk of currency diversified portfolios.