



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

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EACB draft position paper on guidelines on technical aspects of the management of interest rate risk arising from non trading activities (IRRBB) (EBA/CP/2013/23)

The voice of 3.800 local and retail banks, 55 million members, 216 million customers

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A. GENERAL REMARKS

The main activity of cooperative banks is to finance domestic customers' investments - including real estate loans - and to pay interest on their deposits. For the business model of cooperative banks asset and liability management of interest rate risk is a key feature of the retail banking's competitiveness and future profitability.

Real estate loans, mainly fixed rate and whose duration is often more than 12 years - consistently with the creditworthiness of borrowers - represent a significant part of cooperative banks assets. Opposite to Anglo-Saxon practice, for many cooperative banks these assets are kept in the balance sheet and not sold on financial markets as part of securitization transactions. The equipment loans to professionals and companies also represent significant volumes of fixed rate long-term loans.

The need for fixed rate resources is partially covered, in the balance sheet, by customer deposits, refinancing on capital markets, and own funds. Macro-hedging operations (fixed-rate payer swaps) are set up to limit the overall net result of fixed rate loans, based on internal institutions limits.

In a "on going concern" perspective, the objective of the management of interest rate risk in the banking book is to secure the net interest income by limiting volatility to changes in interest rates. Revenues' sensitivity tools are used to measure the scale of potential changes in income of the institution in future periods upon the occurrence of various interest rate scenarios and determine the volume of hedging transactions to implement.

Furthermore, we have some doubts on what the economic value approach would actually show in case of a "one man one vote" co-operative bank with traditional banking activities. For such institutions the motivation of investors are entirely different from the ones directing investors of the joint stock companies. According to our experience, even if the economic value of the co-operative bank is calculated for SREP purposes, its real content for a co-operative bank is questionable.

We believe that applying the guidelines proposed in the consultation paper, without modification, may encourage institutions to assume risk positions on changes in interest rates, in contradiction with the goal sought by the regulator.

While supporting the purpose of promoting convergence of practices across the financial industry, where necessary, we would like to highlight that in our view the draft regulation is not consistent with the objective of the interest rate risk management. More broadly, we believe that it would be hazardous to promote a "one-size fits all" framework with respect to interest rate risk management across the EU, without taking account of specifics of each Member State and of each customer segments.

Finally, it does not seem urgent to launch such a project in the current state of implementation of several extremely heavy regulatory aspects.



B. ANSWERS TO SPECIFIC QUESTIONS

Question 2: Do you agree that a more consistent approach to calculating the effect of the standard supervisory shock is necessary? Will the proposed changes to the text of IRRBB 5 achieve a more consistent approach?

The proposed guidelines suggest that the 'economic value' calculation should be based on a more homogeneous approach, so that it promotes convergence of supervisory practice.

Nevertheless, in our view, the systematic use of the economic value as recommended in the EBA's consultation paper does not reflect adequately the interest rate risk component of retail banking activities.

We acknowledge that the use of convention-based modelling is necessary in the case of non-maturity customer deposits. Such conventions are particularly useful in order to determine appropriate hedging and transfer pricing policies for retail banking activities. We also agree that such conventions should be subject to appropriate governance arrangements, as proposed in the EBA's draft consultative guidelines.

However, we would advise against using systematically such conventions to determine the value of retail banking activities, hence 'outlier' institutions. The rationale behind is twofold:

- those conventions are not reflective of how the balance-sheet of a bank will actually evolve in the future, either in a base case or a stressed scenario,
- the total evaporation of non-maturity deposits at a pre-defined date is a theoretical scenario not reflective of an actual economic scenario relevant for the measurement of retail activities' contribution to future profits and losses. The stressed economic value calculation on positions deriving from such conventions would be particularly misleading as it would disregard interest rate risk taken by a bank beyond the convention-horizon. The use of short-term models appears to be artificially and wrongly prudent and it would give an inadequate sense of comfort only because it would reduce the horizon over which risks are actually analysed. It does not provide, indeed, an accurate view of the interest rate risk possible impacts on a bank' capital solvency ratios in the future.

Consequently, the use of such convention based modelling in the determination of the economic value of retail banking would quite often lead to inappropriate and theoretical outcomes which would not appropriately reflect the actual interest rate risks arising from retail activities. In fact, the relative size of the interest rate risk in the banking book calculated by the economic value approach could be much more relevant for small institutions, which do not calculate the capital requirement for trading book positions, due to the small size of its positions. These institutions, when calculating the IRRBB must include in the positions also those ones for which they have not calculated trading book capital requirements. Therefore, the interest rate risk measure will show the interest rate risk of the entire institution.

Our view is that, as part of the supervisory review process and ICAAP, interest rate risk arising from retail banking activities should primarily reflect volatility of future earnings



rather than a theoretical economic value calculation which would not reflect the actual level of interest rate risk in those activities.

If, nevertheless, the 'economic value' approach will be maintained for all institutions, it would be desirable the publication from authorities of a standardised interest rate shock for the domestic currency, which could be used by small institutions. In our view, in EU Member States, where interest rates are more volatile, and the standardised interest rate shock would be higher than 200 basis point, the calculation of the shock itself can be very burdensome for the majority of small institutions.

Question 3: Do you agree that an average duration of 5 years is appropriate for the behavioural assumption for non-maturity liabilities when calculating the effects of the standard shock. If not, what duration and/or measure would you suggest instead? Should the volatile portion be included in the average, or just the stable core?

We believe that defining a universal constraint on average duration for the behavioural assumption for non-maturity deposits would be inappropriate. In our experience, the average duration of non-maturity deposits may significantly differ from one country to another and between retail activities and other banking activities (eg. private banking, wholesale banking, etc.).

Our view is that, regarding the average duration for the behavioural assumption for non-maturity deposits, the proposed guidelines should primarily focus on requirements to banks to implement effective appropriate governance arrangements rather than on a one-size fits all constraint that would unduly penalise most of retail activities.

Question 5: Do you agree that equity capital should be excluded from the calculation of the impact of the standard shock, when the results are used for supervisory purposes?

This provision in the EBA's proposed guidelines is actually a major area of concern. Many market players in the retail banking industry match their long-term fixed-rate real-estate loans on the asset side of the balance-sheet with long-term liabilities such as equity capital and stable non-maturity deposits.

For retail banks, equity capital is used to finance fixed assets and a part of fixed rates loans. Considering these assets as long-term, naturally leads to consider equity capital as a long-term fixed rate resource.

Thus, in our view taking into account, for the economic value regulatory sensitivity indicator, own funds and fixed rate receivables for their observed lifetime (with regular back testing in accordance with regulatory guidelines) would be justified.

This approach has significant advantages as it promotes stability of the financial system and hence reduces systemic risks.



More specifically, the amount of financial derivatives required in order to effectively hedge mid and long-term interest-rate positions is reduced. Moreover, variations in prepayments rates of mid and long-term loans on the asset side of the balance-sheet are more easily manageable by banks.

In France, for example, real-estate loans are mostly fixed-rate assets. Therefore, the correlation between credit and interest rate risks is drastically reduced if a sharp increase in interest rates occurs. In such conditions, in our view, market players would need to increase their share in variable rate lending if they are required to exclude equity capital from the asset and liability management as part of pillar 2.

The proposals (Section 4.2.2, point c), to exclude own funds and to limit to 5 years the duration of accounts receivable at fixed rates in the assessment of the economic value regulatory sensitivity indicator, are justified by the EBA on the assumption that an opportunity risk may be induced by a too long investment of these resources.

As an example EBA reports that if some assets have a fixed rate at 3% when market spot rate is at 12%, it would be indicated that "the income of the institution could be stabilized but at far lower levels than would have been possible with the new market conditions". In our view such a rationale is correct when the institution has a surplus in resources at fixed rates and may invest these surpluses into remunerated assets at new market conditions.

Where this is not the case, the institution will have to borrow resources at the new market conditions, offsetting the profitability of the operation. Therefore, we believe that it is not correct to assume that taking into account equity and account receivables at fixed rates for their actual lifetime (with regular back testing provided) may lead to an opportunity risk in investments placement.

On the contrary, the too rapid outflow of these resources would exacerbate fixed rate assets surpluses and generate a risk of over-hedging, whose consequences are symmetrical to the risk of under-hedging.

Applying EBA's proposals would require a large amount of hedging - without real economic basis - which would reduce the profitability of the institutions. That would be contrary to the objective of greater resilience of the financial system. Alternatively, it could also lead to a significant use of securitization of real estate loans or to a reduction in their volume.

In fact, the exclusion of equity capital from the interest rate standard shock calculations would increase the level of systemic risks in the financial system. Indeed, this provision would act either as an incentive to reduce the amount of fixed-rate loans granted in the mid and long-term maturity bands or as an incentive to increase the amount of required financial derivatives over the mid and long-term maturity bands in order to hedge open positions in interest-rates, hence conflicting with principle 4.7 (page 36) which rightly provides that "Institutions using derivative instruments to mitigate IRRBB exposures should possess the necessary knowledge and expertise. They need to be aware that hedging with interest rate derivatives is a potentially complex activity that can have unintended consequences, including compounding losses, if used incorrectly. Each institution should demonstrate that it understands the consequences of hedging with interest rate derivatives."



In addition, it is worth noting that, under such a scenario, variations in prepayments rates of mid and long-term maturity loans may lead to an increased level of volatility in the P&L accounts of retail activities, which is clearly not our business model.

The exclusion of equity capital, as proposed by the EBA in this consultative paper, would theoretically be justified in case all assets and liabilities were fair-valued, with a reduce level of uncertainties in the fair-values. Indeed, in such a case, equity capital is the difference between assets and liabilities. But this is far from being the case of most retail activities.

Our view is that the exclusion of equity capital would have significant and undesired effects. Therefore, we strongly advocate against this proposal.