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EACB comments on
EBA Draft RTS supervisory shock scenarios, common modelling and parametric assumptions and what constitutes a large decline for the calculation of the economic value of equity and of the net interest income in accordance with Article 98(5a) CRD
(EBA/CP/2021/36)

General comments

The EACB welcomes the opportunity to comment on the EBA draft RTS on the Supervisory Outliers' Test for the purpose of Interest Rate Risk in the Banking Book (IRRBB).

We welcome the limitation of the Supervisory Outlier Test (SOT) NII to the two parallel scenarios. However, the background for the choice of the reference value of Tier 1 capital is not clear. In our view, the total amount of regulatory own funds is also a meaningful benchmark, which is particularly relevant for the ICAAP. We believe that the EBA did not adequately explain the choice of the reference value of Tier 1 capital.

The requirement of a 1-year period for the calculation horizon, the assumption of a constant balance sheet structure as well as the restrictions to two known regulatory shock scenarios in the form of parallel shifts of the yield curves are understandable.

We welcome the fact that the RTS includes the possibility of using assumptions from the bank's own internal systems for unspecified assumptions in the modelling of risk metrics. Only internal models can make it possible to consider the different business models of the banks and thus ensure appropriate risk measurement.

Technical comments

➢ ***Fair value changes in the Net Interest Income (NII) SOT***

We understand the intention to consider valuation effects in the monitoring of interest rate risks from a supervisory perspective. However, the inclusion of fair value changes in NII does not take into account the existing definition of NII under the accounting view and FINREP, for which the metric of "realized NII" is still to be reported as the difference between interest income and interest expenses. The expanded NII definition including risks from fair value measurements leads to an inconsistency of the simulated risk metrics in the NII standard outlier test compared to the actual accrued and reported interest income. This discrepancy and ambiguity must be considered critically, especially in the context of the disclosure of risk metrics to the public. In our view, this makes the expanded NII definition unsuitable for a comparable and standardizable view on interest rate risks regarding the NII in the narrower sense. Moreover, changes in the present value can only be captured appropriately in the EVE method. Especially if the German HGB is applied, they are fundamentally different from the P&L valuation effects following price movements of the valued products since, in contrast to the EVE approach, valuation or accounting options in the P&L context may distort the actual price movements.

For smaller German institutions in particular, the inclusion of fair value changes in the NII simulation also results in considerable additional costs, as these are not reflected analogously in the HGB view. Effects would be simulated that do not occur in the reported NII. For smaller institutions, this would result in significant additional effort due to the necessary establishment and further development of a separate regulatory risk calculation. If, nonetheless, the decision was made in favor of the inclusion of price movements, HGB terms would have to be used as an alternative. Hence, the threshold would have to be recalibrated appropriately.

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The complexity would also increase if interest-based fees and commissions were included as an additional component in the expanded NII definition, as proposed in Chapter 5 Art. 18 Option 2. Due to their strong focus on retail deposits, institutions would need regular, complex analyses for the inclusion of these positions in the interest rate risk calculation, in which the interest rate responsiveness and the rate transfer to customers in different interest rate shock scenarios is examined.

In the context of the future supervisory outlier test, we thus recommend reverting to the narrow definition of NII. Furthermore, we recommend generally separating the present value, NII and earnings metrics from each other and ask to ensure a clear differentiation of the three different risk views. A mixing of present value aspects within the NII should be avoided. This should also be considered in the future design of the guideline on IRRBB and CSRBB.

- ***Administrative expenses in NII SOT***

In our opinion, the inclusion of administrative costs in Option B for the metric of a "large decline" in NII can potentially lead to less transparency and challenges in the comparability of the resulting metrics between banks.

We would like to point out that this combines the effects from changes in the interest rate risk position of the institutions with effects from cost and income positions that go beyond net interest income, which significantly increases the complexity of the required NII risk metric. Furthermore, it connects unrelated items (reason for administrative costs can be totally disconnected to NII exposure) and creates volatility and dependency in NII limit utilization to non-interest rate items. As a result, a consistent view of the institutions' interest rate risks due to different business models and a comparison of the development of interest rate risks over time is difficult.

The metric can result in arbitrarily high limit utilization even if NII risk is low in absolute number (small denominator problem).

If fair value changes are included, the definition of α in Option B refers to FINREP positions that are also not available in this form for HGB banks. In addition to our general criticism of the current Option 2, we ask for clarification on how HGB banks should deal with such a requirement. Moreover, since there is no direct equivalent in every accounting standard, the calibration of outliers, which is currently already based on a very small sample, is not applicable here.

However, by focusing on NII risk and a capital ratio, Option A represents a metric comparable to the EVE outlier test, which, in our view, is more adequate to identify the ability of institutions to absorb interest rate risks that through their capital resources. For these reasons, we do not consider the presented Option B suitable for the design of the NII Outlier Test and recommend an implementation of Option A.

<u>Answers to selected questions</u>

Q1: Do respondents find the common modelling and parametric assumptions for the purpose of the EVE SOT and the NII SOT in Articles 4 and 5 clear enough and operationally manageable? Specifically, the EBA is seeking comments on the recalibrated lower bound for post-shock IR levels in the EVE SOT and NII SOT as well as on the use of a one-year time horizon and a constant balance sheet with current commercial margins for new business for the NII SOT. Respondents are also kindly requested to express whether they find an inclusion of market value changes in the calculation of the NII SOT clear enough.

The assumptions for the EVE and NII SOT are clear. The one-year time horizon and constant balance sheet assumptions are considered comprehensible provisions to guarantee a standardized and comparable approach in the measurement of NII for the NII SOT. However, the standardization implies that an SOT can

only serve as in indicator for competent authorities to check if closer monitoring might be necessary. The SOTs are not appropriate for risk management purposes.

For the inclusion of fair value changes in the definition of the SOT NII we see challenges arising from the diverging accounting definition of NII (as it is for example also reported in FINREP) in comparison to the NII definition in this context. We also point to the fact that the complexity to measure those risks significantly increases as internal risk measurement and steering is often based on the narrow NII definition.

Furthermore, the possible inclusion of interest-rate sensitive fees and commissions in the extended NII definition (in line with Chapter 5 Article 18 Option 2) would weigh even more on small banks which strongly rely on retail context deposits as complex, regular evaluations would be needed to measure interest rate sensitivity in changing interest rate scenarios. Thus, we recommend the use of the narrow definition in the NII SOT and to measure earnings-related risks in a separate metric.

➢ ***Shock scenarios and lower bound***

With respect to the proposed six supervisory shocks scenarios for EVE and two supervisory shock scenarios for NII, more clarity is needed:

- As the term yield curve has not been defined, we understand that banks are allowed to choose the yield curve deemed appropriate based on their business and circumstances.
- It is not explicitly described whether it is allowed to calculate the impact on EVE by using interest rate sensitivities or that a full revaluation is required.
- For the NII shock scenarios an instantaneous shock of 200 bps for currencies like EUR, USD and some others is not realistic. The consultation paper indicates at page 8 that "*The shock size for the six interest rate shock scenarios is based on historical interest rates. More precisely, for capturing the local interest rate environment and cycle, a historical time series ranging from 2000 to 2015 for various maturities was used to calculate […]*" While institutions are required to use current data, the EBA stops at 2015.

  We therefore propose as alternative scenarios:

  - Either a gradual shock of 200 bps over a period of 1 year
  - Or much lower shock, which should be dependent on the actual level of interest rates or is defined (annually) by the appropriate regulator or competent supervisor.
- We question the adequacy of the floor level changes (from -100bps to -150 bps). In view of bankss typical B/S positions, the floor generally has no adverse effect on worst EVE outcomes, unless a bank has a policy to hedge the market value (i.e. by including commercial margins and discounting with credit spread, see comment below). It certainly has a material impact on the NII SOT results (see also comments on Article 5 (c)).

➢ ***Article 4:***

Generally, Article 4 (Changes in EvE) aligns with the 2018 Guidelines, with more details and a clear explanation. However, we do not agree with point (m) and a new point (n) has been added;

- *"(m) an appropriate general 'risk free' yield curve per currency shall be applied (e.g. swap rate curves). That yield curve shall not include instrument-specific or entity-specific credit spread or liquidity spreads.*
- *(n) In assessing the risk of interest rate-sensitive products that are linked to inflation or other market factors, prudent assumptions shall be applied. These assumptions shall be based on the current/last observed value, on forecasts of a reputable economic research institute or on other generally accepted market practices and shall be generally scenario-independent."*

While the common modelling assumptions are clear, the one size fits all approach of point 4(m) (all cashflow should be discounted on a single risk-free curve) may not be appropriate for all banks. The prescribed approach is a practical option and it is widely used particularly by small and non-complex institutions, at the same time it does not reflect the methodology in use by other industry participants.

We recommend that in addition to a risk free curve approach also a more sophisticated one using risk free plus credit spread can be used by banks according to overall considerations of size, complexity, risk profile of the institutions.

- ***Article 5:***

"(a) Institutions shall reflect in their calculations of the net interest income as referred to Article 98 (5), point (b) the following common modelling and parametric assumptions: Interest income and interest expenses over a one year horizon shall be considered regardless of the maturity and the accounting treatment of the relevant interest rate sensitive non-trading book instruments."

We agree with this, NII SOT calculation would be aligned with the explanation provided in point (a).

"(b) For non-trading book financial instruments accounted at fair value with a maturity of more than one year, the annual change in their market value shall be considered." [point b) will be kept if the option to add market value changes is finally decided by the EBA]

In our opinion, point (b) inclusion of fair value (FV) changes increases complexity and operational burden. Furthermore, the contribution of FV instruments on P&L is largely dependent on accounting rules and jurisdictions. We also see the possibility of overlap as the FV instruments are included in both CSRBB and NII SOT. Moreover, the inclusion of FV changes is likely to have a double counting effect (coupon and value), which may distort the NII results. Therefore, including FV changes may not reflect the actual impact on banks NII. Consequently, it would reduce the transparency and comparability of NII results. In our opinion, the use of the "narrow" definition (without FV changes) is the preferred and realistic choice.

Another complication is the interaction with hedge accounting. Article 5b seems to suggest including fair value changes of hedging instruments in the SOT on NII. The potential ineffectiveness of hedge accounting is determined a posteriori and reporting under a different line item (not as part of interest income). We do not see how a potential hedge ineffectiveness can be calculated a priori under a shock scenario.

"(c) The assumptions established in Article 4, except its points (i) and (j), of this Regulation, shall apply here."

More clarity on the application of Article 4, point (k) would be necessary in application to NII SOT. The consultation refers to historical calibration in very extreme circumstances that, to our mind, does not reflect the percentile typically addressed in stress tests. While we agree on the benefit of having a floor in place, we believe that the setting is not realistic and requires recalibration. Furthermore, there is a dependence of impact of low interest rates with current NMD pricing and applied pricing floors, along with the pricing of other retail products, which at such negative rates would distort the stress NII results.

"(d) Institutions shall include commercial margins and other spread components."

This element appears consistent. The NII SOT will be aligned with the explanation provided in point (d) i.e. commercial margins and spread will be included.

"(e) Institutions shall compute the change in the net interest income under the assumption of a constant balance sheet, where its total size and composition, including on- and off-balance sheet items, shall be maintained by replacing maturing or repricing cash flows with new instruments that have comparable features with regard to the currency, amount and repricing period of the instruments generating the repricing cash flows. Margins of the new instruments shall be based on the margins from recently bought or sold products

with similar characteristics. In the case of instruments with observable market prices recent market spreads shall be used and not historical market spreads."

Members agree with this approach, NII SOT would be aligned with the details provided in point (e).

Q2: Do respondents have any comment related to these two metrics for the specification and the calibration of the test statistic for the large decline in Article 6 for the purpose of NII SOT? Specifically, do respondents find the inclusion of administrative expenses in metric 2 clear enough? Do respondents have any comment on the example on currency aggregation for metric 1 and metric 2?

The inclusion of administrative expenses in metric 2 (Option B) is generally seen as sufficiently clear for the calculation of the NII SOT under this definition. However, as previously illustrated, our members consider administrative expenses as positions that compound the interpretation and measurement of pure interest rate risks among banks with different business models and that hamper comparability across the banking sector. Comparability is further reduced by the inclusion of fair value changes in the NII, since these differ significantly for banks using different accounting standards (e. g. HGB, IFRS).

Including administrative expenses in the equations misrepresents NII results. In the case of the down scenario, the results are more conservative. While for the up scenario, NII results are exaggerated, as a static number will be subtracted from both pre-shock and post-shock values. Thus, it makes the results less intuitive and transparent. Further, from an operational perspective, it is challenging to align risk reporting with financial reporting. Implementing metric 2 takes more time, increases the complexity, and reduces the transparency and comparability of NII results. As detailed in RTS 5.1.5, the results of option 2 are inconsistent across the banks. Moreover, metric 2 is not aligned with the Basel standards.

It is mentioned in Article 6 that sudden (instantaneous) shocks (200 bps up/down) are to be used for NII SOT. Using sudden shocks is a deviation from the existing regulatory reporting. A sudden shock of 200 bps is most unlikely to occur in any situation, while gradual shocks reflect actual rate setting even in stressed markets much more realistically. We recommend to EBA using a gradual shock approach in line with the reasoning above. If EBA decides to apply a sudden shock, the thresholds need to be reviewed and recalibrated.

Furthermore, the definition of the α in Option B refers to FINREP positions that are not available in this form for N-GAAPs banks. In addition to our general criticism of the current Option B, we ask for clarification on how N-GAAPs banks should deal with such a requirement. In particular, the frequencies when amendments in the N-GAAPs are made (i.e. not intra-year) also need to be taken into consideration when specifying this requirement. Moreover, as there is no direct equivalent in every financial reporting, the calibration of outliers, which is currently already based on a very small sample, is in our opinion not applicable here.

We also expect the RTS to consider materiality and proportionality aspects in a more concrete way and adjust the wording accordingly, e.g. for the modelling of behavioral options. Otherwise, the effort required to calculate the SOT increases significantly and is disproportionate to the benefits and knowledge gained.

We would also like to point out that the sample size is not adequate for the calibration of a new, important NII SOT. Besides, the calibration depends on the interest rate environment and hence, in the current extreme situation, is too conservative. Moreover, using a snapshot as of a specific date to calibrate 'outlier thresholds' based on observed deviations between banks does not bring any information on potential 'too large risk' on NII. The calibration needs to be reviewed after the first regular reporting.

Therefore, referring to the metrics presented in Article 6, members signal a clear preference for option A.

Tier 1 capital provides a stable denominator and is aligned with the existing EvE SOT as well as Pillar 3 reporting for IRRBB. A further advantage of option A is its simplicity and its ability to transparently compare among the industry.

Looking at the example of currency aggregation, this is not clear nor does it come with a substantiation of the weight assumptions. The recommended methodology, i.e. applying 50% weights to the gains and 100% weights to loss will make Up- and Down-scenarios incomparable. Further, the recommended methodology for currency aggregation does not accurately picture the aggregated impact.

In the case of European banks, the most significant currency is EUR. Therefore, we suggest one of the following approaches to be considered.

- Simple aggregation of all currencies; or
- 100% weight to EUR, 80% weight to ERM II currencies and 50% weight to other currencies.

Q3: Do respondents consider that all the necessary aspects have been covered in the draft regulatory standard? Do respondents find the provisions clear enough or would any additional clarification be needed on any aspect?

The provisions are generally clear. However, some remarks are needed for the following elements:

- It should be further clarified how the “Baseline global interest rate shock parameters” have been determined and why they are deemed adequate from a regulatory perspective.
- It should be further clarified why the scenarios defined in ANNEX 1 are adequate given that they we calibrated on a time series from 2000-2015 in which the interest rate largely decreased
- Article 1, Paragraph 3 should be further clarified and explain that the currency-specific scenarios do not have to be applied to all currencies with less than 5% of the non-trading book assets once the 90% threshold is reached. Furthermore, a concrete requirement on how these volumes are to be treated is necessary.
- It should be further detailed by the EBA how Article 4 (l) should be applied. Currently, once the absolute value of 80% of the ERM II currency gains is larger than the absolute value of the EUR loss the factor of 50% must be applied. This needs further specification whether the worse recognition would have to be used abruptly or whether a pro rata reduction of the positive effects down to the 50% factor is possible. In the current formulation, very small changes in the portfolio could result in significantly disproportionate changes in the regulatory ratios.
- Furthermore, it remains unclear how to apply positive effects in EUR currency. It should be clarified that the main currency always allows a 100% recognition of the gains.
- More clarification is needed also on currency aggregation.
- In our opinion, FV changes should not be included in the NII SOT calculation for the reasons detailed in response to Question 1 (Article 5 (b)). However, if EBA decides to include FV, more clarity on the methodology and scope will be required.
- As per Article 5, IR floor is also applicable for NII SOT. It should be clarified whether it is correct to assume that upward slope will also be applicable for NII SOT.
- The implementation of this RTS is expected to have a significant impact on the existing internal setup. More clarification is required for the phase of the RTS’ implementation. We believe it would be helpful to have an established communication line with the EBA and/or competent supervisors to get clarity when needed.

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