Nederlandse Vereniging van Banken

CONSULTATION REACTION

Reaction of the Dutch Banking Association (NVB) on the EBA consultation RTS on SOTs

Date: 1 April 2022

The NVB appreciates the opportunity to respond to the EBA consultation on the RTS on the IRRBB Supervisory Outliers Tests. As part of the wider pack (the NVB has also reacted on the GL for IRRBB and CSRBB), the text below represents the collected feedback by Dutch banks for your further consideration.

Implementation date

We first would like to give a general comment with respect to the implementation date. In article 7 the implementation date this RTS is set at 20 days after the publication in the official journal of the European Union. This implementation date is not considered realistically. In all likelihood the Dutch banks will not be able to comply with this timeframe. We propose at least a 6 month implementation time, which starts after the publication in the official journey of the European Union.

Question 1: 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.

Response:

Shock scenarios and lower bound

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

- The term yield curve has not been defined. We assume that the underlying market rates, such as 3M Euribor, or the 5Y swap rates are meant. However, it could also be that e.g. a (annualized or continuously compounding) term structure of zero rates is meant, as most risk management systems use zero rates for shocks and sensitivities.
- In the case of the supervisory shocks for NII, it is not explicitly mentioned, if the shocks for the yield curve can also be applied to the forward rates. Although theoretically not correct, this would greatly simplify the implementation, without compromising materially on the accuracy.

- 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. We propose some other shock scenarios:
  - Either a gradual shift of 200 bps over a period of 1 year
  - Or much lower shock of 100 bps, 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 O/N floor level change (from -100 bps to -150 bps). Although in the recent year the policy of some central banks has been to extend interest rates into negative territory, there are some limits to this new policy. The general consensus is that there is little to no benefit in lowering interest rate to below 100 bps, which is already further than we have seen as of today. Therefore we consider a lower limit of -100 bps both appropriate and conservative. In view of bank's typical B/S positions, the floor generally has no adverse effect on worst EVE outcomes. However, it certainly has a material impact on the NII SOT results (please see our response below on Article 5 (c)).

Article 4:

Generally, Article 4 (Changes in EVE) aligns with 2018 GL, 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.***

Comments:

Although 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 by banks, 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 following approach may also be considered;

- For financial instruments (mainly derivatives), which are subject to central clearing (or any other form of collateral agreement, whereby the O/N rate is received or paid), the cashflow could be discounted on the O/N curve.
- Each financial instrument, which is not subject to central clearing or any other collateral agreement, could be discounted on the standard swap curve (3M of 6M).

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.***

Comments: Agree; NII SOT calculation will 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. [this point b) will be kept if the option to add market value changes is finally decided by the EBA]***

Comments: 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 the NII on 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 4b seems to suggest to include 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 don't 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.***

- **Comments:** More clarity on the application of Article 4, point (k) is requested 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 unrealistic and request re-calibration. 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. We propose an increase of the floor by 5 bps per year, so that negative rates do not extend beyond 20Y.

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

Comments: Agree; 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.***

Comments: We agree with article 5e, except for one detail: It is not always possible to replace repricing instruments with instruments with identical repricing period. E.g. a 30Y mortgage with a 20Y repricing period cannot be rolled over with the same repricing period (20Y), is it extends beyond the (legal) maturity. In this case the repricing period should be maximum 10Y.

Question 2: 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?

Response: Referring to the metrics presented in Article 6, we prefer 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.
Referring to Option B (aka metric 2), 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 (alpha's are not available per currency). 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 shifts reflect actual rate setting even in stressed markets much more realistically. We recommend to EBA using a gradual shift approach in line with the reasoning above. If EBA decides to apply a sudden shock, the thresholds need to be reviewed and recalibrated.
The example of currency aggregation is not clear and does not come with a substantiation of the weight assumptions. 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 should be considered;

(a) Simple aggregation of all currencies; or
(b) 100% weight to EUR and 50% weight to currencies other than EUR

Question 3: 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?

Response:

- More clarification is needed 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. Please clarify 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 during the RTS' implementation. Therefore, we kindly request a communication line with EBA or national supervisors to get clarity as and when needed.
- Treatment of own equity: According to item 14.b of chapter 3 this RTS will specify the treatment of own equity in the SOT for EVE. However, apart from article 4c (all CET1 instruments and other perpetual own funds should be excluded) and the remarks on the QIS analysis, where it is stated the effect of own equity is not taken into account, the treatment of own equity has not been specified in the RTS. Our members have different policies for treating the investment of own equity:
    - It is a common policy to invest own equity in interest sensitive financial instruments and some members do include these investments in the overall interest rate profile of the bank, while others don't. This is in line with the two possible approaches recognized by BCBS 368 (section 2.1, page 36).

We are of the opinion that the EBA should not prescribe whichever policy is appropriate and leave this policy option at the banks' discretion.

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