ABI's comments on the EBA Consultation Paper

"Draft Guidelines on the management of interest rate risk arising from non-trading book activities"

January 2018

POSITION PAPER

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

In the Consultation Paper "Draft Guidelines on the management of interest rate risk arising from non-trading book activities" (henceforth, "the draft Guidelines"), the EBA extends the scope from the management of interest rate risk in the banking book (IRRBB) to include the credit spread risk arising from banking book positions (CSRBB).

The BCBS introduced the CSRBB into the IRRBB standards issued in 2016, without fully defining either content or scope. After which, the EBA introduces the CSRBB into its Guidelines providing only a loose definition. Indeed, the definition of CSRBB contained in the draft Guidelines encompasses "*any kind of spread risk of interest rate sensitive instruments that is not IRRBB or credit risk*".

EU legislation has not yet addressed the CSRBB, thus there is no legal obligation for the EBA to set out urgent provisions in that respect. ABI would, therefore, suggest postponing the introduction of the CSRBB until the new BCBS framework has been transposed into the banking prudential requirements directive (CRD), so that a clearer definition of CSRBB can be provided and the impact of its introduction can be assessed.

Some basic elements, at least, of the CSRBB definition should be clarified, such as its scope (e.g. whether only assets, or both assets and liabilities, are in scope). It would be helpful to clarify the definition by adding numerical examples.

Clarification would also be appreciated as to the definition of basis risk. In paragraph 7 of the draft Guidelines, basis risk is defined as the "*risk arising from the impact of relative changes in interest rates on interest rate sensitive instruments that have similar tenors but are priced using different interest rate indices*". This definition differs from the one in Table 2 (page 33), that seems broader. In addition, paragraph 26 (d) defines basis risk as "*The impact of shock and stress scenarios on positions priced with different interest rate indices (basis risk)*" and, even in this case, the definition seems to be broader. In particular, since the definition in §7 only refers to changes in the spread between similar tenors, it is not clear whether the basis risk should also be referred to instruments indexed to Euribor/Libor with different tenors (e.g. asset Euribor 6 months paid semi-annually vs Euribor 1 month paid monthly).

ABI suggests modifying the definition as follows: "*risk arising from the impact of relative changes in interest rates on interest rate sensitive instruments ~~that have similar tenors but are~~ priced using different interest rate indices*".

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

As already mentioned in response to question 1, concerns arise with respect to the definition of CSRBB and the actual expectations of the EBA as to its identification, monitoring and measurement.

In addition, it is not clear why the impact of interest rates on market value for some type of instruments should be included specifically in the earning perspective (§14). Market value movements are already incorporated in the EVE measurements and, if material, explicit limits should be set on specific instruments. As a consequence, there is no need to insert, as a general provision, the calculation of market value changes in the earning perspective, that would lead to double counting the same risk.

Furthermore, from an implementing point of view, it would be difficult to account for a market value change in the earning perspective, especially in a constant balance sheet framework. Some further clarifications would be needed in this respect.

ABI suggests modifying the text to read:

*"When calculating the impact of interest rate movements ~~in the earnings perspective~~, institutions should consider ~~not only the effects on interest income and expenses, but also~~ the effects of the market value changes of **specific** instruments – depending on accounting treatment – either shown in the profit and loss account or directly in equity (e.g. via other comprehensive income). Institutions should take into account the increase or reduction in earnings and capital over a short- and medium-term horizon resulting from interest rate movements*."

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.**

With respect to the treatment of NPEs, ABI wishes to highlight the need for a flexible approach, allowing banks to take duly into account specificities stemming from strategies, management and accounting of these assets. Indeed, NPEs encompass different categories of assets, each having different "statuses" (e.g. "unlikely to pay", "doubtful loans", etc.) so the way these exposures are treated for IRRBB management purposes may differ.

The "General Provisions" should, therefore, require that all the assumptions regarding the treatment of NPEs be clearly formalized, without an imposition to consider all NPEs as interest-sensitive instruments. This would ensure a sufficient amount of flexibility to reflect banks' internal management approach, business model and IRRBB modelling (also with respect to consideration of provisions).

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.**

Clarification is needed on point f) of paragraph 26, with respect to the "impact of embedded losses" and to the possible consideration of "embedded gains".

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. Please justify your answer.**

In ABI's opinion, a capital charge should only be required when the bank is exposed to a risk of loss. Therefore, only elements linked to the risk of actual losses, and not to the variability of earnings, should properly be considered for the internal capital allocation. Paragraph 30 point (e) mentions fluctuations in earnings giving rise to effects like "the revision of the dividend policy"; these cannot be considered as losses nor are they necessarily correlated to the level of the net interest income.

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

As to the governance, the draft Guidelines ask institutions to express their risk appetite for IRRBB in terms of the maximum acceptable short-term and long-term impact of fluctuating interest rates on both earnings and economic value, and to reflect all this into limits.

Given that an appropriate definition of the short-term and long-term horizons is not straightforward, and that, when assessing the impact on earnings and on economic value, different time horizons are applied, ABI suggests deleting the reference to the short-term and long-term horizons, modifying paragraph 33 as follows: *"The institution's risk appetite for IRRBB should be expressed in terms of the maximum* *acceptable ~~short term and long term~~ impact of fluctuating interest rates on both earnings and economic value and should be reflected in limits."*

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

As to section 4.4, clarification is needed with respect to the actual definition of "non-maturity deposits". Doubts arise since in the draft Guidelines it seems that "non-maturity deposits" are assumed to be deposits "without any specific repricing dates". In this respect, an explicit definition would be helpful and, above all, clarity would be welcome about what we should understand a "specific" repricing date to be.

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.**

While carrying out this comparison does not pose a challenge, in ABI's opinion, the purport of such an exercise is questionable and it is not clear what purpose the outcome could serve. Caution should be exercised in the reading of these results and ABI would also advise against disclosing the results of such a comparison in any way.

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.**

Paragraph 113 (b)

ABI wishes to have clarification on point (b) of paragraph 113, and in particular on whether this provision addresses only "small trading book business" within the meaning of Article 94 of the CRR (if the bank uses the allowed derogation). In other words, the interest rate risk would automatically be considered captured in another risk measure if the bank applies the capital requirement under the market risk framework. Therefore, ABI would suggest clarifying that point (b) of paragraph 113 only applies to banks that take advantage of the derogation granted in Article 94 of the CRR. Otherwise, clarification is needed as to the meaning of "small trading book business" for the purposes of this provision.

Paragraph 113 (f)

ABI suggests clarifying that, for the SOT calculation, banks are allowed to use internal measures based on cash-flow adjustment for credit risk (i.e. expected future losses) in order to align SOT to internal cash-flow modelling. ABI suggests modifying §113(f) as follows: "*The cash flows from interest rate sensitive instruments should include any repayment of principal, any repricing of principal and any interest payments. Institutions should be allowed to take into account adjustments to reflect expected future credit losses according to the banks' IMS;*".

ABI also suggests clarifying that, in keeping with their IMS, banks can use their forwarding multi-curve approach for projections of expected interest from floating-rate instruments.

Paragraph 113 (g)

In order to align SOT to internal calculation methods, ABI suggests modifying §113(g) as follows: "*NPEs treated as general interest rate sensitive instruments according to banks' IMS should be modelled to reflect expected cash flows and their timing. NPEs should be net of provisions;*".

Paragraph 113 (k)

The Guidelines should clarify that the floor should be applied to the risk-free curves and transposed consistently (keeping the basis between the different curves) to all the other curves. ABI suggests rephrasing §113(k) as follows: "*A maturity-dependent post-shock interest rate floor should be applied for each currency and curve starting with -150 basis points for immediate maturities. This floor should increase by 5 basis points per year, eventually reaching 0 % for maturities of 30 years and more. The floor should be applied consistently among the different curves used in the calculation;*".

Paragraph 113 (m)

In ABI's opinion, banks should be allowed to aggregate the sensitivities in different currencies according to their IMS. Since it is possible, under each scenario, for there to be at least one currency with an EVE loss, the SOT would result in EVE losses under all scenarios, which is less informative about the actual exposure to the IRRBB. For example, if under the "parallel-up" shock, the euro exposure has a +10 bln EVE change and the USD shows a -0.001 bln EVE change, the SOT will show the -0.001 bln loss rather than the more significant result of +10 bln EVE changes. This would explain a possible -10 bln that would be shown under the "parallel-down" shock.

Paragraph 113 (n)

It should be clarified whether the "*appropriate general 'risk-free' curve*" refers only to the discounting curve or whether this single risk-free curve should be used both for discounting and forwarding (thus ignoring the basis risk). Explicit reference to a discounting curve would be helpful. Besides, ABI proposes to allow banks which adopt a multi-curve approach in their IMS to use different risk-free curves for discounting according to their IMS and depending on the instruments involved (e.g. financial derivatives and cash instruments).

ABI suggests amending §113(n) to read: "*at least one discounting risk-free rate per currency according to the IMS should be applied […]*"

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?

ABI welcomes the transitional period granted to banks falling into SREP category 3 and 4 before the application of the new measures, since the latter will require significant implementing effort, particularly on the part of the smaller banks.

As to the application of the proportionality principle, while acknowledging that the "Sophistication Matrix" (Annex II of the draft Guidelines) is a useful tool, ABI would like to point out that explicitly mentioning, in each section of the Guidelines, the specific obligations that smaller banks are not expected to comply with would be very helpful. This would provide small banks with certainty about the supervisory expectations.

In particular, it would be very helpful to clarify that category 3 institutions should perform basis risk analysis according to Section 4 only if their exposure to this risk is material (providing clear guidance on materiality definition).

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.)?

Interest rate risk arising from pension obligations and pension plans assets is generally managed and measured separately from the IRRBB framework.

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.

ABI believes that risk measures for supervisory purposes should reflect the institution’s internal risk management practices.

With respect to the consideration of commercial margins cash flows, banks should be allowed to include or exclude them in accordance with their internal IRRBB management approach, providing disclosure to the competent authority.

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.

The internal systems have, generally speaking, some flexibility according to the definitions of IRRBB used to produce the internal measurements.

The cost of adapting the systems could vary a lot depending on what is intended for ‘commercial margin’ and ‘other spread component’ to be excluded.

In order to reduce implementing costs, giving banks the possibility to use their own internal definition, properly formalized and approved by internal corporate bodies, would be preferable.

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.

Generally speaking, the proposed linear lower bound would determine unrealistic post-shock spot and forward curves. See also the response to question 9.

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.

ABI considers the thresholds to be suitable. ABI would suggest introducing an exception to the overall 90% threshold (not present in the BCBS standards), in case the remainder is very fragmented across multiple currencies.

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?

It depends on the bank's balance sheet composition, hedging activity and degree of currency diversification. In any case, non-consideration of positive changes jeopardizes the accuracy of the measurement, since the final result will disregard some components.

See also the response to question 9.