Brussels, 1st April 2022

MM

EACB comments on
EBA Draft RTS specifying standardised and simplified standardised methodologies to evaluate the risks arising from potential changes in interest rates that affect both the economic value of equity and the net interest income of an institution's non-trading book activities in accordance with 84(5)
(EBA/CP/2021/38)

General comments

The EACB welcomes the opportunity to comment on the EBA draft RTS on standardised and simplified standardised methodologies on Interest Rate Risk in the Banking Book (IRRBB).

We welcome that the regulatory standardized approaches and simplified standardized approaches for present value (EVE) and periodic (NII) interest rate risk in the banking book mandated in CRD are provided with a concrete framework, strengthening supervisory convergence in this area where institutions' processes are not deemed adequate. In the same vein, we welcome that the new standardized approaches can only be required by supervisors under clear conditions, and that internal models will continue to be used for supervisory outlier tests. In our view, only banks' own internal measurement methods, including the necessary expertise as well as the risk measurement methods, can ensure an appropriate bank-specific management of IRRBB.

We therefore would emphasize that the standardized approaches shall not be used for comparative purposes, e.g. as benchmarks or for supervisory analyses. The standardized approaches can only serve to determine a conservative risk metric where the assessment of specific institutions reveals criticalities, and not as a reference point in any way. We recommend that the EBA adds clearer language in this respect in this RTS in the introduction as well as in section 4, better defining the concrete scope of application.

In general, the application of the standardized approach for IRRBB would lead to a significant increase in systematic model risk for a growing number of banks. If the standardized model delivers inappropriate results, this leads to a systematic misevaluation of interest rate risks and therefore potential spillover across the banking sector. In addition to the divergences in pricing, especially of customer business, a wide recourse to the fallback solution would not be beneficial neither for banks nor for regulators and market participants. The standardized approach should only be required for the institutions described in para. 3 Article 84 of CRD, i.e. those that cannot demonstrate adequate internal systems, which we would expect being rather rare cases.

It should be central to the definition of the new regulatory requirements for the standardized models that there is no incentive for institutions to rely on the fallback solution neglecting internal capacities and risk management skills. We also see that some aspects are not adequately taken into account in the draft RTS and major challenges in the implementation would be expected, especially for smaller and medium-sized banks.

Technical comments

- ***(Simplified) standardised approach for EVE***

General approach

We understand the general approach and support the clarifications regarding ambiguities present in the previous standardized approach designed by the Basel Committee, especially regarding the modelling of

EACB AISBL – Secretariat • Rue de l'Industrie 26-38 • B-1040 Brussels
Tel: (+32 2) 230 11 24 • Fax (+32 2) 230 06 49 • Enterprise 0896.081.149 • lobbying register 4172526951-19
www.eacb.coop • e-mail : secretariat@eacb.coop

demand and savings deposits as well as the definition of automatic options. However, it is apparent that significant components of the standardized approach and the simplified standardized approach are not suitable for small and medium-sized institutions. This is particularly evident in the requirements for the consideration of automatic options, non-maturing deposits, and early repayments, which are detailed below.

Automatic options

The valuation of automatic options according to Art. 12 via a scenario-based full valuation is not possible for many small banks, as they do not have the technical and business capabilities to carry out such a valuation. For small, non-complex institutions, on the other hand, the simplified standardized approach is a possibility to consider these options. We support such an approach, but our members point out that the resulting outcomes are not accurate. In addition, we believe that a materiality threshold should be introduced for automatic options below which they do not have to be considered.

Non-maturing deposits

We generally consider the modelling of non-maturing deposits in the standardized approach using "core" and "non-core" volumes, which is common in many banks, to be a reasonable choice for smaller institutions as well. This enables the banks to take into account, within a clearly defined framework, the bank- and customer-specific characteristics of the deposits in the standardized approach. However, we consider the additional split into "stable" and "non-stable" to be redundant, as the approaches are not clearly distinguishable and, moreover, interest is mixed with liquidity considerations.

Additionally, the specification of concrete parameters for modelling in no way reflects our understanding of an appropriate model and cannot be a substitute for internal risk management. Institution-specific models also reflect the actual expected interest rate changes of a bank. This synchronisation between pricing and risk modelling will be significantly restricted by the specification of "core" requirements (e.g., caps, restrictions concerning cash flow slotting) and thus lead to incorrect risk measurement. We would reiterate that standardized approaches in the IRRBB environment cannot be a substitute for appropriate internal models.

Prepayments

We welcome the EBA's proposals to establish a clear standardized approach for modelling of prepayments. However, it must be ensured that the effort for implementation is appropriate according to the materiality of influencing factors. The thresholds defined for the consideration of early repayments are not appropriate in our view. Currently, early repayments must be modelled as soon as 2% of the total asset position consist of fixed-interest assets with early repayment rights according to Art. 8. This would affect many banks with their fixed-interest asset business. However, this threshold only includes the volume and not the impact of such repayment rights, which is not appropriate in our view. We propose to introduce thresholds that refer to the expected impact on the risk metrics instead of the absolute volume of products with options.

- ***(Simplified) standardised approach for NII***

General approach

We understand the introduction of a standardized approach and simplified standardized approach but note that for smaller and medium-sized institutions, the approaches, as currently presented, will pose significant challenges. In addition to the NII-specific challenges, please see also the comments on Articles 7-12 formulated for the EVE standardized approach.

Commercial margins

Under the assumption formulated by the EBA in the "Explanatory Box" under Art. 18 that commercial margins are not significantly sensitive to interest rates, the effect of margin payments on the delta-NII is not relevant,

except for minimal changes due to scenario-specific cash flow changes. However, the determination of the effects from margin adjustments additionally requires the allocation of the interest payments into repricing time buckets introduced in Art. 19, which produces significant additional effort. For regulatory purposes, mainly the risk measure of delta-NII is relevant, if Option 1A in the SOT for NII – which is our preferred option – prevails. Therefore, we propose to prescribe only the delta-NII calculation in the standardized approach and to neglect the absolute NII including margin effects, given that it is appropriately conservative.

Basis risk

We understand the chosen approach and the underlying assumptions. We welcome the bank-specific definition of scenarios, as this is the only way to consider the actual situation of the bank. Consistently with the other elements, however, we consider the introduction of threshold values to be reasonable at this point. Especially in the retail banking environment, there are many institutions with an immaterial share of variable-rate products with different reference curves.

Fair-Value positions

We would like to point out that many small and medium-sized banks prepare financial statements according to N-GAAPs (Austria, Germany). However, the current definition of fair value effects only applies to IFRS banks, which makes it difficult for N-GAAPs banks to implement the requirements.

In general, the share of items that have accounting effects in different interest rate scenarios on the P&L is low, especially for smaller banks, and so this should also be considered via an appropriate threshold value.

If the narrow definition of the NII prevails in the supervisory outlier test, we point out that this must also be reflected in the standardized models.

Simplified approach

The standardized approach as well as the simplified standardized approach are too complex for smaller, non-complex institutions. In particular, the approaches should be applicable in banks that cannot demonstrate adequate risk management for interest rate risks and are required to do so by the regulator. With appropriate conservatism and with clear labelling as a conservative transitional solution, we therefore propose a simplification of the approach to a pure delta NII approach (in the narrower sense).

Without the effects criticized above for automatic options, fair value positions and basis risk, this leads to a significantly simplified delta-NII risk measure, which produces less work for the banks and would be more manageable.

Answers to selected questions

Q1: What is the materiality of prepayments for floating rate instruments and what are the underlying factors? Would you prefer the inclusion of a requirement in Article 6 for institutions to estimate prepayments for these instruments?

We welcome the exclusion of prepayments on floating rate products as they are generally deemed immaterial. Besides the already small impact on the overall risk metrics in the different scenarios, prepayments on floating rate products are typically independent of the interest environment and therefore do not have a significant impact on the Delta EVE and Delta NII risk metrics which are the key result of this standardized approach.

Q2: Do respondents find that the required determination of stable/non-stable deposits, and core/non-core deposits as described in Article 7 is reflective of the risks and operationally implementable? In case of any

unintended consequence or undesirable effect on certain business models or specific activities, please kindly provide concrete examples.

We generally consider the modelling of non-maturing deposits in the standardized approach using "core" and "non-core" volumes, which is common in many banks, to be a reasonable choice for smaller institutions as well. This enables banks to take into account, within a clearly defined framework, the bank- and customer-specific characteristics of the deposits in the standardized approach. However, we consider the additional subdivision into "stable" and "non-stable" to be redundant, as the approaches are not clearly distinguishable and, moreover, interest is mixed with liquidity considerations. Furthermore, it is confusing that the definition of the stable portion refers to "the current level of interest rates" (p. 18), but "upward and downward movements" of the last ten years are to be considered in the determination (Art. 7, p. 23).

Moreover, the exclusion of wholesale NMDs from financial customers is not consistent with the Basel standard.

Q3: Do respondents find that the required determination and application of a conditional prepayment rate and term deposit redemption rate as described in Article 8 and 9 is reflective of the risks and operationally implementable? In case of any unintended consequence or undesirable effect on certain business models or specific activities, please kindly provide concrete examples.

Our members find the determination and application of a conditional prepayment rate as described in Article 8 operationally implementable. However, we do not agree with the definition of the exception/threshold in Art. 8 para. 2. Rather than defining a threshold based on 2% the total of fixed rate loans we suggest a threshold based on the impact such options will have on the results. In the current case, a bank that allows a full loan repayment for 1,9% of their positions referred to in Art. 2(2) would not have to model their prepayment whereas a bank that allows a 5% repayment for 2% of their positions would have to include the impact. A determination of the materiality based on the percentage of possible prepayments is deemed more adequate.

Throughout the document, it should be made clear that the estimation must be applied consistently over time (cf. Art. 9) and it is not the estimator itself that has to be consistent (cf. p. 9 vs. p. 26).

Q4: Is the treatment of fixed rate loan commitments to retail counterparties clear and are there other instruments with retail counterparties where a behavioural approach to optionality should be taken?

Yes, the approach is clear. However, we propose to include a materiality threshold under which such instruments must be included.

Q5: *Do respondents find that the required determination of the impact of a 25% increase in implicit volatility as described in Article 12 is operationally implementable?*

Only few small and medium-size banks without a trading book have the capacity to implement such an approach using a full revaluation. The current definition of products that fall underneath is too wide, making it impossible for such banks to implement if not at the expense of a disproportionate effort. A materiality threshold and further simplification are needed (such as in Art. 23(2) for the simplified standardized approach).

Examples of products that currently fall under the definition:

- Floating rate products with an implicit floor of 0% either on the total costumer rate or the reference rate
- Wholesale fixed term deposits with an early redemption right under Article 9(3)
- Implicit 0% Floors on Non-maturing Retail deposits

In addition, we ask for clarifications concerning the empirical information on which the assumption of the 25% increase is based.

Q6: Do respondents find that the required slotting of repricing cash flows in accordance with the second dimension of original maturity/reference term as described in Article 13 is operationally implementable?

The approach is comprehensive. However, it will be challenging to collect the relevant data and operationally challenging to perform this calculation. Therefore, we emphasize that banks should not be required to calculate the approach in addition to the internal modelling approaches, but only if their internal model is deemed not satisfactory.

Especially the cash flow slotting according to shock scenarios is far too complex and the economic rationale is not clear since the core component is the part of the NMDs that "*is unlikely to reprice even under significant changes in the interest rate environment*".

Furthermore, we do not see the rationale behind the structure of the reference term time buckets and we believe that a more detailed elaboration is needed on the economic background on why this is deemed adequate.

Q7: *Do respondents find it practical how the determination of several components of the NII calculation, with in particular the fair value component of Article 20 and the fair value component of automatic options of Article 15, is generally based on the processes used for the EVE calculation (in particular Article 16 and Article 12)?*

Overall we believe that consistency in the process makes sense. However, we further suggest including a threshold under which banks are eligible to disregard such effects in the standardized approach to ensure that such an effort-intensive calculation is only performed if the underlying risk is actually material for the bank. Furthermore, if the narrow definition of NII prevails in the regulatory outlier test, we additionally point out that this must also be considered in the definition of the standardised models.

Q8: *Do respondents find that the calculation of the net interest income add-on for basis risk is reflective of the risk and operationally implementable?*

In this regard much depends on the size and complexity of the institutions. While it could make sense for larger and more complex institutions, for the smaller ones who are likely to be the main users of a standardized model it is far too complex and not relevant. We suggest including a threshold under which banks are eligible to disregard such effects in the standardized approach to ensure that such an effort-intensive calculation is only performed if the underlying risk is actually material for the bank.

Q9: *Do respondents find that the adjustments in the Simplified Standardised Approach as set out in Article 23 and 24 are operationally implementable, and do they find that any other simplification would be appropriate?*

On the EVE approach

The simplifications for small and non-complex institutes are not sufficient to support implementation by simpler retail banks. While we welcome the simplifications regarding automatic options (Art. 23(2), see comments under Question 5), the predefined volumes divert significantly from the average retail bank. This can be applied for the calculation of a conservative risk metric, however, as elaborated above, this approach cannot be used for the comparison to internal models or for other benchmark activities.

On the NII approach

We appreciate the effort to simplify the NII Standardized Approach for small, non-complex institutions. However, the requirements are still rather complex (data requirements, options, margins, basis risk, fair value changes).

In line with the EVE simplified Standardized Approach, the treatment of NMDs does not reflect the actual behaviour for local and small banks where deposits are one of their core competences. Hence, we generally suggest allowing more flexibility and change the wording on the simplified standardized approach from "shall" to "may" to allow for implementation of a more adequate approach.

We further suggest to only consider the reinvestment of the principal in line with the constant balance sheet definition as the priority and focus on the delta NII in a narrow sense. This will simplify the currently very complex calculation and make the implementation much more feasible. It is particularly relevant as the approach should also be implementable for banks where the interest rate risk management was deemed inadequate.

It should be made clear that, regarding the empirical determination of commercial margins, no breakdown into counterparties is required.

Q10: *Do respondents find that all the necessary aspects are covered and the steps and assumptions for the evaluation of EVE and NII as laid out in the standardised approach and simplified standardised approach clear enough and operationally implementable?*

We would like to point out that inconsistencies may arise if internal systems were used for one perspective (EVE/NII) and the (simplified) standardised methodology was mandatory for the respective other perspective. For instance, in the case of NMDs, different cash flows could be modelled in the two perspectives: one cash flow that appropriately maps the institution's planned interest rate adjustment policy and one cash flow constructed according to prudential regulations. In this case, different control signals could arise, not only from the differences between the EVE and NII methods but also from the diverging cash flows. This would significantly complicate the interpretation of the results. Solutions to this problem should also be explored. One option would be the simultaneous application of the (simplified) standardised methodology in both perspectives – even if a satisfactory internal system exists for one of them.

Moreover, we would like to emphasize some of our comments under the previous questions.

- The current standardized model is hardly implementable for small and medium non-complex banks due to high requirements and the complexity of the approach (in particular regarding Art. 12)
- The standardized approaches and even more so the simplified approaches – given the strong deviation from adequate internal risk management, pricing and steering – do not reflect the actual economic risk and can only be used as a conservative interim model that should not be used as a benchmark or for other (supervisory) comparative purposes. This should be pointed out explicitly in the RTS. We emphasize that banks should not be required to calculate the approach (e.g. for the purposes mentioned above) unless their internal model is deemed not satisfactory.
- All the additional add-ons for basis risk, margin risk, automatic options and prepayment options are too complex and need simplifications as well as (relevant) materiality thresholds.

- We generally suggest simplifying the overall approaches with a model that focuses solely on the delta NII in a narrow sense to allow a much more implementable and adequate calculation

We would also reiterate the following:

- p. 18, (15), p. 23, Art. 4 – small and non-complex institutions cannot model pass through rates because of price effects, as pricing effects can only be mapped by means of complex derivatives (for example, a deposit of € 100 the interest rate of which is determined by passing through 70 % of a current market interest rate to the customer, is no longer worth € 100 in the event of an interest rate adjustment. This problem can be circumvented using moving averages).
- p. 19, 2(b) – Please clarify which instruments are subsumed by "*non-interest derivatives … referencing an interest rate*".
- p. 19 Art. 3 (1) – materiality definition per currency?
- p. 20, Definition "increase of short-term interest rates" for purpose of Art. 23 is missing.

Contact:

For further information or questions on this paper, please contact:

- Mr. Volker Heegemann, Head of Department (v.heegemann@eacb.coop)
- Mr. Marco Mancino, Deputy head of Department, Banking Regulation (m.mancino@eacb.coop)