EBA/CP/2021/36
2 December 2021

Consultation Paper

Draft Regulatory Technical Standards specifying 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) of Directive 2013/36/EU.

1. Responding to this consultation

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions summarised in 5.2.

Comments are most helpful if they:

- Respond to the question stated;
- Indicate the specific point to which a comment relates;
- Contain a clear rationale;
- Provide evidence to support the views wxpressed/rational proposed;and
- Describe any alternative regulatory choices the EBA should consider.

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 4 April 2022. A public consultation period of four months is proposed on an exceptional basis, considering the concomitant publication of 3 different regulatory products on the same topic. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EU) 1725/2018 of the European Parliament and of the Council of 23 October 2018. Further information on data protection can be found under the Legal notice section of the EBA website.

The EAPB has the following general observations relating to the draft Regulatory Technical Standards specifying supervisory shock scenarios.

- Supervisory one-size-fits-all measures are not suitable to appropriately reflect bank individual characteristics and risk situations.
- Therefore, there must be no automatism between the SOT and any supervisory measures, in particular capital add-ons.
- Instead, SOT results should be taken as an indication for the need to monitor and examine certain institutions more closely.
- If the respective thresholds are breached, the institution needs to be granted
    - the opportunity to submit their own opinion and explanation and
    - sufficient time for remedial actions.
- Moreover, no full integration of the SOT methodologies into the institutions' internal measurement and management of IRRBB should be stipulated. This would likely result in undesired incentives for the actual management of IRRBB.
- The NII definition is too broad.
    - The inclusion of fair value effects is not in line with FINREP and in particular hardly feasible for institutions under national GAAP. Differences in accounting methods applied among institutions could distort the comparability of indicators between institutions, on the scope of fair value instruments.
    - The inclusion of fees and commissions is overly burdensome for many institutions.
- For this reason and for sake of comparability, we propose a narrow NII definition that excludes costs and fees and valuation components. Otherwise, the EVE and NII perspective would be mixed and the NII SOT would become unnecessarily complex.
- The performed QIS is not a representative basis for the calibration of the SOT. We expect that, eventually, many institutions are going to breach at least one of the proposed thresholds. This is far from being in accordance with the actual meaning of an "outlier".
- The calibration should ensure that no more than 10% of institutions (both on EU and each national level) are categorized as outliers. This is necessary to allow for a risk-based, focused supervisory approach and to keep the operative burden for competent authorities manageable.
- with respect to the two alternative metrics for the NII SOT there is a pronounced preference for metric A among EAPB members.

- Whereas we recognize the supervisory shock scenarios aim to identify sensitivity to an unusually large change in interest rates, it questions whether an instantaneous shock of 200 bps for currencies like EUR, GBP, and USD is realistic. We propose EBA considers a more gradual shock scenario for NII
- EAPB ask whether EBA can corroborate its recalibration of the post-shock floor on interest as even after the extremely low rates under the ECB's TLTROs we have not seen evidence the previous floor of 100 base points has been breached.

<u>Question 1:</u> 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.
We respond EBA with reference to Question 1 as follows

Information technology allows for institutions to project cash flow schedules using actual maturities and tenures of instruments. The Regulatory Technical Standards (RTS) describe a model that requires institutions to assign cash flows to pre-defined maturity and repricing buckets. To implement this, banks would have to implement a separate, inaccurate cash flow model for the sole purpose of performing the supervisory shock scenarios.

● EAPB asks EBA to clarify whether the bucketing methodology is optional and whether institutions may use a more accurate model based on actual cash flow schedules and corresponding discount and forward rates. If so, EAPB asks EBA to, explicitly, state the system of bucketing cash flows is an option but not a requirement. If not, EAPB asks EBA how it can reconcile such an inaccurate method with the requirements ex section 4.4 of the concurrently proposed guidelines on the management of IRRBB and CSRBB that require institutions to have a satisfactory internal system for management of IRRBB.

The RTS further requires institutions to apply a floor to shocked rates. The description of this floor does not coincide with the repricing buckets, nor with their midpoints. It, furthermore, is unclear whether the increments in the floors are stepwise or continuous.

Furthermore, 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.

● We ask EBA to clarify whether institutions may apply the increments to the floors they must apply to shocked interest rates in a continuous manner. If so, EAPB asks EBA to, explicitly, state institutions may apply the increments in a continuous manner. If not, EAPB asks EBA to clarify how institutions must derive the floor for individual repricing maturity buckets.

Article 5(b) requires institutions to consider the annual 'market-value' changes for non-trading book financial instruments accounted at 'fair value' with a maturity of more than one year. Institutions can observe 'market values' only for traded instruments. 'Fair value' is an accounting concept that does not imply a 'market value' exists for the instrument.

● EAPB asks EBA to clarify how institutions should determine a market value if the instrument does not trade.

Most accounting regimes require institutions to carry traded and over-the-counter (OTC) derivatives at 'fair value.' Institutions use such instruments to hedge interest and credit risk arising from exposures in their banking book. They may carry such instruments at amortised cost and apply hedge accounting to offset the change in the fair value of the hedging instrument. Hedge accounting does not reclassify the hedged instrument as 'fair value' instrument. Article 5(b), therefore, leads to spurious measurement of IRRBB for net interest income (NII). To avoid spurious risk measures, institutions must add hedge-accounting rules to their interest rate-risk models for NII. The inclusion of accounting rules transforms an economic measure like NII into an accounting measure like Earnings. In particular the RTS relating to the inclusion of fair-value changes is complex and burdensome as, typically, such changes are the subject of accounting systems and not risk systems.

● EAPB asks EBA to clarify how the focus on accounting principles contributes to effective management of IRRBB from an economic perspective.

Article 5(d) requires institutions to include current commercial margins and other spread components when calculating the changes in net interest income.

● EAPB asks EBA to clarify whether institutions must derive current commercial margins and spreads when there is no trade in the instrument and there is no trade in a close substitute for the instrument.

The banking books of promotional and public banks will hold loans for which there are no deep and liquid markets. Commercial margins and spreads, generally, will reflect the banks' missions and not the interest rate environment. Both the current and proposed guidelines on the management of IRRBB allow institutions to exclude commercial margins and other spread components from the economic value measure.

● EAPB suggests EBA to extend the possibility to exclude commercial margins and spreads from the calculation of the supervisory shock scenarios for EVE to those for NII.

<u>Question 2:</u> 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?
We respond EBA with reference to Question 2 as follows.

● EAPB has a strong preference for metric 1.

The explanatory box following Article 6 remarks with respect to option A, involving metric 1 for the identification of a large decline in NII from the supervisory shock scenario, that option A fails to account for elements other than NII-related elements in the assessment of the sustainability of the business operations.

We remark that option B, involving metric 2, is highly sensitive to one-off elements in expected NII after costs. These affect the denominator, resulting in a potentially unstable measure. Metric 2, particularly, fails to discern between changes in expenses that can be transient in nature and net interest income. Metric 2 further uses reported FINREP numbers that may reflect accounting or regulatory views rather than 'economic' relevance. We further question whether any measure over a one-year horizon allows for assessment of the sustainability of the business operations. Metric 2, therefore, appears to be more complex and unstable than metric 1 whilst not adding useful information for the assessment of the institution's sustainability of NII.

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?

We respond EBA with reference to Question 3 as follows.

● The EAPB asks EBA to clarify whether the bucketing methodology is optional and whether institutions may use a more accurate model using actual cash flow schedules and corresponding discount and forward rates.

● The EAPB asks EBA to clarify whether institutions may apply the increments to the floors they must apply to shocked interest rates in a continuous manner.

● The EAPB asks EBA to clarify whether 'interest rates' referred to in article 3 are 'discount rates' or 'spot rates?

● The EAPB asks EBA to clarify how institutions must attribute administrative expenses across currencies if EBA chooses to implement metric 2 referred to in article 6. In particular, the EAPB asks EBA to clarify how institutions must attribute costs of currency hedges to the relevant currencies.

● EAPB considers that the RTS should enter into force no sooner than 6 months after publication date to enable banks to adapt their reporting and tools.