

**European Banking Authority (EBA) Consultation Paper (CP) on the
Draft Regulatory Technical Standards 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) of Directive 2013/36/EU**

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Link to Consultation Paper: [CP Draft RTS on SA.pdf \(europa.eu\)](#)

Glossary

BB:	Banking Book (i.e. non-Trading Book)
BCBS:	Basel Committee on Banking Supervision
bp:	basis point (0.01%)
CET1:	Common Equity Tier One
CP:	Consultation Paper
CRD:	Capital Requirement Directive
CRR:	Capital Requirement Regulation
CSRBB:	Credit Spread Risk in the Banking Book
EBA:	European Banking Authority
EV:	Economic Value
EVE:	Economic Value of Equity
EBF:	European Banking Federation
FBF:	French Banking Federation
IMS:	Internal Management System
IRRBB:	Interest Rate Risk in the Banking Book
NII:	Net Interest Income
NMD:	Non-Maturing Deposit
OCI:	Other Comprehensive Income
RTS:	Regulatory Technical Standard
SOT:	Supervisory Outlier Test
Standard:	Standards on Interest Rate Risk in the Banking Book published by BCBS in April 2016

Executive Summary:

The French Banking Federation (FBF) welcomes the opportunity to express the views of the French banking industry on the public consultation on ***Draft Regulatory Technical Standards specifying standardized and simplified standardized 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) of Directive 2013/36/EU***. In this context, we herewith provide you with our general remarks and responses to the questions listed in the Consultation Paper (CP). We appreciate your consideration about our comments and remain at your disposal for further clarifications.

Article 84(5) of Capital Requirement Directive (*CRD*) tasks the European Banking Authority (*EBA*) with developing a Regulatory Technical Standard (*RTS*) to define a standardised methodology that institutions may use for the purpose of evaluating the [interest rate] risks [...], including a simplified standardised methodology for small and non-complex institutions.

It is worth reminding that the Basel Committee on Banking Supervision (*BCBS*) has clearly mentioned that IRRBB is not amenable to standardization as any standardized measure of IRRBB would lose its risk-sensitivity and would fail to be relevant for supervisory measures:

*§3. The Committee noted the industry's feedback on the feasibility of a Pillar 1 approach to IRRBB, in particular **the complexities involved in formulating a standardised measure of IRRBB which would be both sufficiently accurate and risk-sensitive to allow it to act as a means of setting regulatory capital requirements.** The Committee concludes that the heterogeneous nature of IRRBB would be more appropriately captured in Pillar 2.*

In that context, **a standardized (or simplified) methodology would definitely not be risk sensitive. Such a standardized or simplified methodology cannot be sensibly described as “reliable”.**

It is noted that there is no evidence provided by *EBA* to support adequacy of the suggested standardized / simplified factors.

Therefore, we have very strong reservations for the definition of such approach(es) and have very strong concerns that it could have to be applied to a bank. As Article 98(3-4) refers to the standardized and simplified methodologies that the competent authority could impose for the *evaluation* of risks, **we recommend that the *RTS* clarifies that such an imposition should be:**

- **Limited to the evaluation** (which will be necessarily wrong as mentioned before) **and not for the actual management** (as banks would have to manage with flawed steering metrics that would be detrimental to the actual risk management) as clearly mentioned in Art.98(3) “*A competent authority may require an institution to use the standardised methodology referred to in paragraph 1 where the internal systems implemented by that institution for the purpose of evaluating the risks referred to in that paragraph are not satisfactory.*”
- **Conditional on competent authority having demonstrated that the *standardized* (resp. *simplified*) methodology would be more relevant than the *IMS* that it would pretend substituting.**

And we recommend that, as specified in the *CRD*, it is made clear that the *standardized* (*simplified*) methodology does not have to be implemented, unless imposed or elected by the bank, and should not be used as a benchmark for *IMS*.

We alert standardized (simplified) methodology users on the consequences of their use for actual risk management as it would lead to manage with a flawed steering wheel.

As an example, the suggested caps on Non-Maturing Deposits (*NMDs*) may significantly distort the economic representation of interest rate risk.

As another illustration, it is not appropriate to use a stress volatility when measuring the sensitivity of automatic options in the objective of hedging them. With such an approach, one would be led to un-appropriate delta hedge of the options since the measurement would be distorted. It should be

stressed that such a stress on volatility is neither performed in trading book nor required by the regulators for trading books regulations. By the way, requiring this to be applied for the Supervisory Outlier Test (SOT) on Economic Value of Equity (EVE) is inconsistent with the objective of the SOT EVE which is to measure the sensitivity to changes in interest rates.

We recommend that it is made clear that the standardized (simplified) methodology does not have to be implemented, unless imposed or elected by the bank (with the reserves expressed above) and should not be used as a benchmark for IMS.

The CP envisages changing the definition of commonly understood Net Interest Income (NII) to include changes in fair values of instruments even though they are not part of NII. This appears as a deviation from the CRR mandate that explicitly refers to NII. It also deviates from BCBS Standards that is quite explicit that it refers to NII excluding changes in fair values that don't affect NII. This would also be at odds with actual risk management – this would lead to taking decision of hedge based only on accounting considerations and not economic considerations – and would introduce overlapping between NII measures and Economic Value (EV) measures while they should be complementary. **NII should be kept as defined by interest income and expenses.**

Last but not least, the final application date should be aligned with the *Guideline* and the *RTS on Supervisory Outlier Tests*.

Consultation paper EBA/CP/2021/38

EBA CP Questions:

Question 1: 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?

For retail sector, floating rate loans represent a small fraction of French banks assets. Add to that, prepayments of floating rate loans are low for French banks. The main underlying factors are purely structural (divorce, unemployment, or death) and we agree on the fact that they are not dependant to the level to market interest rates. We can also notice these underlying factors are stable over time, we do not believe this is necessary to stress the prepayment for these instruments for banks using SA. For Corporate sector, the prepayments of floating rates loans are not linked to the change of interest rate, we do not believe this is necessary to stress the prepayment for these instruments for banks using SA.

Question 2: 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.

The suggested limitation on NMD would have different impact on different products, jurisdiction or business models. For instance, in some countries the deposits are mostly variable instruments while in other countries a significant portion would be non-remunerated or fixed. In the latter case, NMD's may have long duration that are significantly higher than the envisaged caps. Even when some NMD

products may have a sensitivity to changes in interest rates, they may have duration longer than the envisaged caps.

Add to that, we recall EBA that **IRRBB is a symmetric risk**. Therefore, the references to so-called 'conservatism' or 'prudence' are mis-conceived: it is as risky to adopt a too short interest rate profile then a too long interest rate profile. Managing based on flawed metrics may increase or decrease the interest rate risk exposure of a bank and may even cause losses that can hardly be a regulatory or supervisory objective.

That is why, such limitations could generate wrong interest rate risk measurement and management decisions and could generate more risk in the end. **A more open approach is needed.**

From an operational point of view, we consider this approach highly complex and difficult to implement. The multiplication and complexity of assumptions in this approach will complicate the automation of reports. Essential manual restatements will necessarily increase the risk of operational difficulties.

Question 3: 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.

In most circumstances, the term deposits have limited duration, which makes the prepayment modelling not so material an issue. However, the response to #2 apply.

Question 4: Is the treatment of fixed rate loan commitments to retail counterparties clear and are there other instruments with retail counterparties where a behavioral approach to optionality should be taken?

No question regarding the treatment of fixed loans commitments, no other instrument identified to have a behaviour approach.

Question 5: 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?

We would appreciate if the EBA could provide more detail on the relevance of this hypothesis. We do not understand the value of applying this assumption to both purchased and sold options: in case of asymmetry in the balance sheet, this could lead to additional products if the institution is long in bought options and short in sold options.

Operationally, this would involve implementing a 25% increase in volatility for the six scenarios needed to calculate the EVE, which is likely to overburden a complex production process (implying a multiplication of option valuation matrix tables).

In addition to the production burdens mentioned above, we believe that such assumptions (including too many flat-rate add-ons) could ultimately alter the correct view of risk.

Question 6: 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 projection requests the integration of the cash flow of fixed rate instruments for the determination of the projected NII. This approach is not compliant with a rolled balance sheet hypothesis, and we do

not perceive its interest (which is neither included in the internal approach nor requested in the calculation of the *SOT NII*). We would appreciate that *EBA* provides more explanation, and concrete example, of the implementation of this hypothesis.

We also note the integration of such cash flows would complexity severely the production of the projected *NII*.

Question 7: 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)?

Net Interest Income should be... Net Interest Income as it is commonly understood

- **The CP envisages to change the definition of commonly understood Net Interest Income (*NII*) to include changes in fair values of instruments** even though they are not part of *NII*. This appears as a deviation from the *CRR* mandate that explicitly refers to *NII*. It also deviates from *BCBS Standards* that is quite explicit that it refers to *NII* excluding changes in fair values that don't affect *NII*. This would also be at odds with actual risk management and would introduce overlapping between *NII* measures and Economic Value (*EV*) measures while they should be complementary. ***NII* should be kept as defined by interest income and expenses.**

Net Interest Income (*NII*) means net interest income that is widely defined as the portion that impact the profit and loss statement.

Considering the changes in Other Comprehensive Income (*OCI*) and/or in capital as *NII* would be inconsistent with commonly accepted definition of *NII*, with *CRD* and with *BCBS*.

It would be so flawed as it would disincentivize to hedge with cash flow hedging instruments as their changes in fair value would be considered as a risk to *NII* while they are entered into precisely to make *NII* less sensitive.

We urge *EBA* to adhere to the common definition of *NII*, not to invent another definition of its own and to be consistent to the mandate provided by *CRD* that refers to Net Interest Income. *EBA* would deviate from its mandate by extending the definition of *NII*.

It is reminded that the economic value perspective has also to be considered and that the extension of *NII* measures would create overlap with *EV* measures.

Several paragraphs need to be fixed of this deviation:

15. For the purposes of these Guidelines, the net interest income upon which to calculate the impact of interest rate or credit spread movements should be determined by the interest income and expenses, and the market value changes of 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 the amount of profit and losses ~~and capital~~ over short- and medium-term horizons resulting from interest rate or credit spread movements.

§27(e) the impact on economic value and net interest income ~~(including effects on the fair value through other comprehensive income (FVOCI) portfolio)~~ of mismatched positions in different currencies;

§31(d) The relative importance of interest rate sensitive instruments (including interest rate derivatives) in the non-trading book, with potential effects shown ~~either in the profit and loss account or directly in equity (e.g. via other comprehensive income);~~

§44(c) In defining their risk appetites, institutions should take account of net interest income risks that may arise as a consequence of the accounting treatment of transactions in the non-trading book. The risk to net interest income may not be limited to interest income and expenses: the effects of changes in interest rates on the market value of instruments that, depending on accounting treatment, are reflected either through the profit and loss account or directly in equity (via other comprehensive income), should be taken into account separately. Institutions should particularly take into account the impact related to embedded optionalities in fair value instruments under ongoing interest rate shocks and stress scenarios. Institutions should also take into account the potential impact on the P&L accounts of hedging interest rate derivatives if their effectiveness was hampered by interest rate changes.

Some extracts from *BCBS Standard* relating to earnings are worth reminding as they clearly highlight that earnings are considered as *NII*:

*§8. IRRBB refers to the current or prospective risk to the bank's capital and earnings arising from adverse movements in interest rates that affect the bank's banking book positions. When interest rates change, the present value and timing of future cash flows change. This in turn changes the underlying value of a bank's assets, liabilities and off-balance sheet items and hence its economic value. Changes in interest rates also affect a bank's **earnings by altering interest rate-sensitive income and expenses, affecting its net interest income (NII)**. Excessive IRRBB can pose a significant threat to a bank's current capital base and/or future earnings if not managed appropriately.*

*§69. The level of IRRBB exposure should be measured and disclosed. Specifically, banks must disclose the measured Δ EVE and **Δ NII** under the prescribed interest rate shock scenarios set out in Annex 2.*

*§93. A bank could also be considered to have excessive risk relative to **earnings if its shocked Δ NII** was such that the bank would not have sufficient income to maintain its normal business operations.*

Article 20 should be deleted.

Question 8: Do respondents find that the calculation of the net interest income add-on for basis risk is reflective of the risk and operationally implementable?

When identified as material, banks already take into account the basis risk.

Question 9: 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?

The implementation would be complex and lead to non-risk sensitive results.

Question 10: 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?

Overview:

Article 84(5) of Capital Requirement Directive (*CRD*) tasks the European Banking Authority (*EBA*) with developing a Regulatory Technical Standard (*RTS*) to define a standardised methodology that institutions may use for the purpose of evaluating the [interest rate] risks [...], including a simplified standardised methodology for small and non-complex institutions.

It is worth reminding that the Basel Committee on Banking Supervision (*BCBS*) has clearly mentioned that IRRBB is not amenable to standardization as any standardized measure of IRRBB would lose its risk-sensitivity and would fail to be relevant for supervisory measures:

*§3. The Committee noted the industry's feedback on the feasibility of a Pillar 1 approach to IRRBB, in particular **the complexities involved in formulating a standardised measure of IRRBB which would be both sufficiently accurate and risk-sensitive to allow it to act as a means of setting regulatory capital requirements.** The Committee concludes that the heterogeneous nature of IRRBB would be more appropriately captured in Pillar 2.*

In that context, **a standardized (or simplified) methodology is doomed to fail being risk sensitivity. Such a standardized or simplified methodology cannot be sensibly described as “reliable”.**

It is noted that there is no evidence provided by *EBA* to support adequacy of the suggested standardized / simplified factors.

Therefore, we have very strong reservations for the definition of such approach(es) and have very strong concerns that it could have to be applied to a bank. As Article 98(3-4) refers to the standardized and simplified methodologies that the competent authority could impose for the *evaluation* of risks, **we recommend that the *RTS* clarifies that such an imposition should be:**

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As another illustration, it is not appropriate to use a stress volatility when measuring the sensitivity of automatic options in the objective of hedging them. With such an approach, one would be led to un-

appropriate delta hedge of the options since the measurement would be distorted. It should be stressed that such a stress on volatility is neither performed in trading book nor required by the regulators for trading books regulations. By the way, requiring this to be applied for the Supervisory Outlier Test (SOT) on Economic Value of Equity (EVE) is inconsistent with the objective of the SOT EVE which is to measure the sensitivity to changes in interest rates.

We recommend that it is made clear that the standardized (simplified) methodology does not have to be implemented, unless imposed or elected by the bank (with the reserves expressed above) and should not be used as a benchmark for IMS.

The CP envisages changing the definition of commonly understood Net Interest Income (NII) to include changes in fair values of instruments even though they are not part of NII. This appears as a deviation from the CRR mandate that explicitly refers to NII. It also deviates from BCBS Standards that is quite explicit that it refers to NII excluding changes in fair values that don't affect NII. This would also be at odds with actual risk management – this would lead to taking decision of hedge based only on accounting considerations and not economic considerations – and would introduce overlapping between NII measures and Economic Value (EV) measures while they should be complementary. **NII should be kept as defined by interest income and expenses.**

Last but not least, **the final application date should be aligned with the Guideline and the RTS on Supervisory Outlier Tests.**

Detailed Comments

Pursuant to the mandate of Directive 2013/36/EU (art. 84 §5), the EBA has published in December 2021 a standardised approach (SA) and simplified standardised approach (S-SA) methodology. The purpose of these methodologies is the evaluation of the risks arising from potential changes in interest rates that affect both the Economic Value of Equity (EVE) and the Net Interest Income (NII) of an institution's non-trading book activities.

We understand from the CRD5 directive (Article 84) that institutions may apply a standardized (or simplified) approach for the evaluation of their IRRBB:

- i) At institutions' discretions for the standardized (or simplified standardized method in case the institution is sufficiently small in size and low in complexity)
- ii) At supervisor requirement only if it considers that the institution's internal approach is not satisfactory to manage its interest rate risk (or if the simplified standard approach is not adapted to the complexity of the entity). **In that case, we recommend specifying in the RTS that such imposition should be evidenced by competent authority that the standardized (simplified) methodology represents more accurately the risk with more risk sensitivity than the IMS it aims at substituting.**

Our main comments / recommendations are presented below:

- The proposed methodology: assumptions (e.g. treatment of *NMD*, add-on on options related to a 25% increase in volatility, exclusion of equity) are not economically founded, complex, and are detrimental to the risk sensitivity of *IRRBB* measurement.
- The specific treatment to limit *NMD*'s (in both amounts and maturity) in the standardized approach is not substantiated and is really difficult to understand. Moreover, from an operational point of view the implementation of such an approach is highly complex due to the several re-treatments:
 - In some markets, sight deposits have always been zero cost (therefore fixed rate liability), even when in situations of high and very quick increase of rates (2005-2008) and even during the European sovereign debt crisis (2011-2012). Such caps on duration on *NMD* would alter the assessment of the actual risk taken by the concerned banks. It may push the banks to take forced, unnecessary and potentially risky derivatives positions.
 - *NMD*s may be rate dependent. Setting a fixed cap on the stability does not make economic sense.
 - More generally, we recall *EBA* that *IRRBB* is a symmetric risk: in case, the retained model maturity is less than the optimal model maturity, there is a loss (for assets) and a gain (for liabilities) of opportunity in case rates are increasing and vice versa in case rates are decreasing. Therefore, an increase of variability of the income.
This is suboptimal even when considering convexity effects. In case of stable market conditions, a cap on maturity removes an opportunity to balance the losses related to the convexity management when market moves.
 - Any undue ill-calibrated parameter would force the banks using SA to manage on wrong basis which could actually increase actual risks and cause losses for them, which cannot hardly be an objective for competent authority.
 - From an operational point of view, the multiplication and complexity of assumptions in this approach will complicate the report automation, with manual restatements will necessarily increase the risk of operational error.
- The inclusion of an add on for bought / sold interest rate automatic options computed with a 25% shock of volatility is not so clear: our understanding is that bought and sold options are valued differently though in many cases, bought options hedge sold option and vice versa. Therefore, we do not understand the rationale of treating differently an option and its hedge.
- Furthermore, for interest rate hedging purposes, using implicit volatility without shock is the best estimate, and it avoids distorting the delta and gamma of the options.
- For the calculation of the *NII*, it requests to reinvest the cash flow of fixed rate instruments into the projection. This approach is not compliant with a constant balance sheet hypothesis, and we do not perceive its value added (which is neither included in the internal approach nor requested in the calculation of the *SOT NII*).
- Like commercial margins and own equity capital in the internal approach, institutions applying the standard method should be able to integrate equity (on documentation and after validation by the regulator). Excluding equity simply fails to recognize equity stability. This approach penalizes institutions that made the effort to be highly capitalized. As explained above, *IRRBB* is symmetrical; a gradual (more measured) approach would be more in line with the potential for loss (eg. 80% of the equity could be maintained considering that 20% corresponds to a 2% shock on an investment over an average period of 10 years).

Overall, we believe this approach is too restrictive (especially in comparison with the guidelines) and that more flexibility could be allowed. The possibility of deviating from certain assumptions (after validation by the regulator during a check for example) should be possible. The institution should have the possibility to not apply strictly all articles, after validation by the supervisor.

Finally, this approach should not be considered as a benchmark or a floor for the internal or inter-institutional approach.