German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Position Paper

Comments on the current discussion concerning the forthcoming model for the measurement of supervisory own funds to potentially cover interest rate risks and credit spread risks in the banking book

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General Comments

On principle, we hold the view that there is no need for the development of a standardised supervisory model concerning a capital charge for interest rate risk in the banking book as part of Pillar 1; what is more, such a model might even prove to be outright dangerous. By virtue of said regulatory action, the supervisor directly interferes with banks' core competency. Furthermore, the "Basel interest rate shock" offers a starting point for any potential regulatory capital charge imposed top-down as part of Pillar 2; as a toolkit, this is fit for purpose.

Given that the potential regulatory steps will impact the further discussion in a profound way, we see a compelling need for an initial specification of the prioritisation and of the objects which may have to be treated under Pillar 1. The same applies to the proposed capital requirement for credit spread risks in the banking book. We would like to reiterate one of our earlier points, i.e. that the various Basel working groups (along with the Task Force on Interest Rate Risk and also the Trading Book Working Group) seem to have been assigned one and the same task. Furthermore, the various concepts are often interpreted in a heterogeneous manner; we would like to strongly suggest providing one single and coherent, unambiguous concept clarification. The TFIR letter dated 16 June 2014 includes a number of concepts or, moreover, language which is in need of clarification in order to ensure a shared understanding. In view the potentially forthcoming consistent BCBS recommendations, it is worth highlighting that - whilst the terminology might be used by way of analogy - there is tremendous international heterogeneity concerning the practical application of these terms during day-to-day banking operations. In order to arrive at one coherent regulatory framework and so as to avoid overlaps with other regulatory provisions (e.g. Liquidity Coverage Ratio, Fundamental Review of the Trading Book) we strongly suggest a more detailed concept clarification.

There are sound reasons that prevented the emergence of uniform standards for the measurement and management of interest rate risks in the industry. In order to capture each and any impact both on revenues but also on equity or, moreover, the banks' financial position, many banks feature the complementary use of several measurement approaches. All methods are faced with a major challenge: For positions where capital or interest rates are locked in for an indefinite period, assumptions have to be made concerning the interest rate adjustment behaviour in the customer business. A standardisation would *de facto* force all banks to use universally applicable assumptions.

This involves risks: The growing importance of supervisory ratios for an assessment of the interest rate risk might create clear incentives for an alignment of the risk management (and, by default, the customer product policy) with supervisory requirements. One of our biggest concerns relates to capital charges that lack risk sensitivity, compulsory hedging transactions that are inadequate with regard to the underlying risk, increased revenue volatility, a reduction of the low-risk transactions due to an erosion of margins, a concentration process concerning the business policies and shorter maturities in lending business. Banks would no longer be able to provide savings products to customers which are not interest sensitive or to provide savings products that are largely unattached to the interest rate level. At the same time, an inappropriate capital charge will potentially have unintended consequences on the economy's loan supply.

In the past, the German supervisor used to ask banks to develop their own approaches for reflecting the interest rate risk under Pillar 2 preferably on the basis of their own business strategy / corporate policy. Yet, the approaches for Pillar 1 currently under discussion imply a development headed into

the opposite direction. Furthermore, in the monthly report by Deutsche Bundesbank of June 2012, the supervisor revisits the BCBS' results presented in the paper "International Convergence of Capital Measurement and Capital Standards – A Revised Framework Agreement" by the BCBS where the BCBS expresses its view that "… interest rate risks in the banking book merit support from capital, they are omitted from the calculation of the regulatory minimum capital requirements under Pillar 1 of the Basel framework. According to the Committee, this is because of the major differences between internationally active banks in terms of the nature of the interest rate risks they face and their processes for measuring them". We welcome this view and should like to highlight the point that this situation has not seen any change at all. Rather, today more than ever, there is a need for a differentiated assessment. This is due to the fact that – during a historic interest rate low - the future interest rate adjustment behaviour of banks may become extremely heterogeneous. This assumption is based on an assessment of future customer behaviour. Provided that - in the event of rising interest rates - clients will respond increasingly sensitive, banks will have to make various concessions in terms of the margins. Otherwise they might run the risk that clients will increasingly migrate elsewhere. Depending on the risk position and on the proximity to the supervisory ratios' maximum limits, this trend will feature varying degrees. This individual parameter needs to be accommodated in banks' risk management. Hence, banks need to be free to set individual, bespoke parameters allowing them to forecast their clients' interest sensitivity as accurately as possible. This is the only way for correctly reporting the interest rate risk and avoiding any undesirable effects.

In 2012, the MaRisk ratio changed the capital planning process resulting in a close dovetailing of the regulatory and internal capital charge, i.e. Pillar 1 and Pillar 2. Due to this intertwinement, interest rate risks considered under Pillar 2 already have a restrictive impact on Pillar 1 meaning that there is no need for an additional or, moreover, two-fold consideration under Pillar 1. Hence, the own funds requirements under Pillar 1 would translate into a corresponding waiver/non-consideration of the own fund requirements for interest rate risk from Pillar 2.

We also have extremely strong reservations over the capital requirement for credit spread risks from own account investments. Credit spread risks are closely linked to the counterparty risk (default risks and migration risks). Hence, the credit spread risks are sufficiently covered by the existing supervisory rules (including but not limited to Pillar 1 rules). For banking book exposures, credit spread changes are usually irrelevant. This is due to the fact that they are not measured at fair value; also, it is because, normally, they will be held until final maturity. However, the capital requirement for credit spread risk introduces elements of the fair value perspective (with potential procyclicality effect). Yet, the last financial crisis was further compounded precisely by procylicality. Besides, controlling the consequences of the capital requirement would be difficult. We strongly recommend abandoning the plans for an additional capital requirement for credit spread risks in the banking book. By way of summary: Based on the foregoing, we have extremely strong reservations over the supervisory plans concerning regulatory capital requirements for interest rate risks and the credit spread risks in the banking book and would like to suggest considering alternative regulatory options.

We would like to express our gratitude to BaFin and the Bundesbank for the timely inclusion in the supervisory deliberations during the telephone conference call on 28 March 2014 as well as during the hearing held at Deutsche Bundesbank on 6 May 2014. We welcome the opportunity to lend our continued constructive support during the ongoing discussions by sharing our comments below on specific items pertaining to the supervisory model presented to us on said occasions. Furthermore, we would like to briefly highlight a number of issues surrounding the issue of the TFIR presented in the letter to the German Banking Industry of 16 June 2014. However, since the respective concept

clarifications are still pending in a number of areas, our remarks below are of a purely preliminary nature and we would very much appreciate the opportunity to comment on the aforementioned letter in greater detail at a later point.

Specific comments

Measurement methodology

Wherever possible, we recommend convergence between bank's internal approaches and supervisory approaches; this will keep the additional costs for parallel measurement processes as low as possible or, moreover, minimise misguided incentives in the area of risk management. Hence, the corridor of supervisory approaches needs to provide a sufficient degree of latitude.

On principle, interest rate risks can be measured either on the basis of Net Interest Income or Economic Value at Risk approach. Both approaches satisfy their specific requirements. There are a number of reasons why banks give preference to one approach over the other. Hence, also only an approach that is in line with the bank's internal control system should become mandatory. Otherwise, it might result in conflicting management impulses (for instance, in cases where a Net Interest Income approach has to be applied as a complement to the Economic Value at Risk approach). Hybrid approaches are unheard of and furthermore unhelpful. This is due to the fact that the Net Interest Income and the Economic Value at Risk approach adopt fundamentally different perspectives. Whilst the Net Interest Income approach focuses on accounting figures, the latter play no role in an Economic Value at Risk approach. Given that both approaches do not necessarily yield identical results in different interest rate scenarios, we hold the view that a supervisory capital charge which is based on both methods would be counterproductive.

In Germany, banks either use the Net Interest Income or Economic Value at Risk approach; but there are few banks where both approaches are applied on a complementary basis. However, it is worth noting that, in most German banks, the measurement and control of interest rate risk is based on the present value. According to statistics by Deutsche Bundesbank, only amongst savings banks and cooperative banks, the respective underlying volumes of the NMD's amount to at least 41% of the customer deposits and 38% of the customer loans.

For this reason, we hold the view that - when it comes to a basis for the development of a supervisory model for capital measurement - an Economic Value approach is fit for purpose. According to the TFIR's letter of 16 June 2014 there are plans for the development of a static, supervisory Net Interest Income approach. In our view, one of the key advantages offered by Net Interest Income approaches consists in the dynamic simulation of the portfolios. A static approach, however, would not deliver sufficiently meaningful results.

The TFIR letter of 16 June 2014 calls for an adequate reflection of basis risk in the various approaches. We hold the view that a consideration of the basis risk is problematic and we have extremely strong doubts over the usefulness of generally applicable high-level rules. Normally, existing approaches will not differentiate between the interest rate risk's four components (repricing risk, yield curve risk, basis risk, option risk). It is worth noting that many banks manage interest rate risks on the basis of the entire bank's cash flow, i.e. these risk components will be considered rather implicitly. By no means should the proposed rules impose a mandatory separation of the four components of interest rate risk for all banks regarding the assessment and quantification of interest rate risk.

The supervisor mentioned a six month holding period already in the description of the fundamental shape and design of the forthcoming supervisory model. For us, this begs the question whether the six month holding period currently under discussion refers to the observation period for deriving interest scenarios. In this case, the envisaged rolling six month intervals for determining the interest scenarios might considerably diverge from that period which is usually required for hedging interest rate risks in the banking book. Rather, provided this is necessary, the outstanding positions could be hedged within a few days. Therefore, a six month lag is far too long. This is especially true for an over-night interest rate risk simulation.

Interest shock scenarios

We welcome plans to link the interest shock scenarios to the interest rate level of the respective currency. During the inception of the forthcoming interest shock scenarios which depend on the interest rate it has to be ensured that the shift of the interest rate level does not produce any extraordinary changes in the measurement results and thus in the result of the regulatory capital charge.

It is important that the number of scenarios be kept to a modicum. Even if there is good technical support, every simulation run will absorb major resources. In our view, the following four scenarios are perfectly sufficient for simulation purposes: parallel shift, steepening, warp, twist.

Furthermore, netting the different impacts of the interest rate changes on the individual time buckets should become an option. This is the only way for ensuring that existing collateral relations will be covered in the form of a potential capital charge in a risk adequate manner.

When calculating the interest rates for the interest shock scenarios, banks should be granted the freedom to calculate the interest curve on the basis of bank-specific maturities buckets. This would help prevent an obligation for banks to apply interest rate charges to maturities that are difficult to observe in the market and / or which are not used by banks for the purposes of their own interest rate risk management.

Since interest shock scenarios vary based on the interest level, depending on the currency, this results in different interest shock scenarios. Provided banks foreign currency exposures in the banking book do not amount to more than 5% of the entire banking book, there should be no need for a mandatory separate calculation of currency specific interest shock scenarios. Instead, all banking book exposures shall be assessed in one and the same way by means of the euro specific interest shock scenarios.

Non maturity deposits (NMDs)

The correct modelling of NMDs is the most important element of the interest rate risk measurement in the banking book. According to the Bundesbank statistics of April 2014, the volume available to banks for funding purposes is at least approximately EUR 2.2 trillion in Germany (measured on the basis of sight and savings deposits). The capacity of a bank to provide an appropriate view of the volume, the investment duration and the interest rate sensitivity of this funding source forms part of its decisive competitive factors.

Therefore, banks can usually draw upon many years of experience in the modelling and validation of customer's NMDs. There are various approaches for modelling purposes. They all have in common that the respective products are assigned to groups or moreover, clusters that are as homogenous as possible. Depending on the number of products, legal idiosyncrasies, markets and the observed customer behaviour, a very high number of clusters may be necessary. On principle, for a bank this invariably involves a trade-off between the number of clusters that have to be defined and the volatility within the clusters that results from decreasing cluster sizes. Finding an optimum in this regard presents a major challenge.

The deposit volumes in the various clusters are modelled on the basis of historic observations; they reflect the pace at which deposits build up as well as seasonal effects or campaigns, assumptions concerning the future interest rate adjustment behaviour and expert estimates. These assumptions are subjected to regular stress tests and validation.

There are numerous private banks and central savings banks at the regional level (Landesbanken) which determine the duration and the volume (fictitious maturity) of these exposures by means of replicating portfolios; in the banks of the network of cooperative as well as the savings banks, however, the most widely used approach is the approach of the moving average. Along with this, also the interest elasticity concept is applied.

On principle, a uniform supervisory rule on the clustering of exposures with no fixed interest rate and no capital commitment as well as the supervisory regime for the assignment of durations will therefore lack an adequate degree of risk differentiation. Our reservations are owed to the fact that it is not possible to reach the necessary level of granularity under standardised rules. We are firmly convinced that the proposed supervisory breakdown on the basis of two customer groups (wholesale and retail clients) or, moreover, on the basis of transactional and non-transactional is completely inadequate and unfit for purpose.

Furthermore, we hold the view that imposing an average, let alone a maximum duration is particularly detrimental. The duration and the fixed interest rate of these deposits are determined by the bank's product policy and they reflect the interest rate adjustment. Determining the interest rate adjustment behaviour is part of the corporate strategy. Hence, this entrepreneurial freedom shall and may not be restricted by supervisory rules. Therefore, this whole issue has a material influence on the measurement of interest rate risks. However, in terms of the risk management, the implementation of rigid rules for the treatment of these exposures would cement a duality thus incurring a growing divide of "supervisory" risk and "actual" risk. This will increase the likelihood of any undesirable effects. In an attempt to reduce the regulatory capital charge, corporate decisions – including but not limited to interest rate risk hedges or changes to the terms and conditions offered in order to attract more deposits - are taken on the basis of wrong behaviouristic assumptions and also lead to P&L distortions. In light of the above, also in the supervisory model there is a compelling need to give all banks the opportunity to continue using their tested and tried approaches and to continue drawing upon parameter settings geared to their individual position.

In our view, the EBA Consultation Paper on the revised guidelines on technical aspects of the management of interest rate risk (EBA/CP/2013/23) primarily addresses liquidity aspects in the field of customer accounts without specific repricing dates (NMDs) which are inappropriate for a true and fair view of the respective exposure's interest rate risks. When it comes to NMDs, there needs to be a

differentiation as to which risk is in the focus of the observation. Whilst these exposures – similar to the fixed interest rate business – equally always include an interest rate risk and liquidity risk element, any assessment of these risks shall and may not be based on identical parameters for assessing the respective interest rate or capital commitment relation. Hence, there is compelling need for a separation on the basis of the interest rate risk and of the liquidity risk. After all, the liquidity risk is already covered at a different juncture.

Explicit options and embedded options

During the interest rate risk measurement, banks should be given the opportunity to recognise implicit and explicit options (e.g. call rights under the German Civil Code, call rights of the (Covered Bond) Pfandbrief debtors, swaptions, interest rate options). Here, too, in order to consider these embedded options during the measurement, banks can draw upon a certain bandwidth of approaches. Approaches range from the mere recognition of the contractually fixed term to maturity to approximation methods which are based on historical analyses and even include option price models. The same applies to the control where these options are frequently hedged by means of swap or swaptions. The forthcoming supervisory approaches should allow banks to use data obtained on the basis of their own methodology.

The pure cash-flow based approach currently discussed for the purposes of a supervisory model does not allow accommodating all these processes. In order to adequately take into account the different business models by all banks, at least for all implicit and explicit derivatives, institutes which predicated their own interest rate management on other approaches need to be allowed to draw upon these approaches when it comes to calculating supervisory requirements.

Credit spread risks

In our understanding, the underlying rationale of reviewing the need for a capital charge for credit spread risks in the banking book consists in reducing the scope for arbitrage between the banking book and the trading book. In this context, we would therefore like to highlight the work conducted by the BCBS' Trading Book Working Group. In our view, the fact that switching to a different capital charge after changing an exposure between the books this working group has already removed any incentive for arbitrage. Furthermore, a change between the books is subject to very restrictive limitations.

We hold the view that the inclusion of credit spread risks under Pillar 1 is inappropriate. However, in case this current proposal will be upheld despite our reservations, we would like to highlight the following aspects pertaining to the supervisory deliberations which have taken place to date:

We welcome the fact that sovereign risk has been excluded from the debate. After all, we share the view that there is a need for a holistic supervisory approach. Developing different approaches for the various supervisory regulatory areas (e.g. credit risk, liquidity risk, large exposures regime and credit spread risk) is not a constructive move.

Furthermore, the debate should only be confined to fungible securities featuring a market price. First, this is a *condition sine qua non* for the measurability of credit spread risks. Therefore, the customer loans shall and may not be included. Furthermore, we hold the view that it will be extremely difficult

to draw the lines between the individual components of credit spread risks in a precise manner. Therefore, more likely than not, a capital charge for credit spread risks in the banking book would lead to a clear duplication of the capital charge for credit risks. Hence, for us this begs the more fundamental question to which extent credit spread risks in the banking book can be deemed a material supervisory ratio in the first place. In view of the introduction of additional regulatory capital buffer under Pillar 1 slated for 2016 we feel that - at this juncture - the credit spread risks are negligible; instead, we trust that the regulatory capital buffers will absorb losses resulting from further risks which have not been defined in greater detail.

At the present point in time, and given the fact that there is still a lack of further information, a more in-depth discussion of the measurement approaches presented would be premature on our part. The deliberations concerning the sensitivity based clustering of credit spread risks with respect to rating, maturity and asset class do not feature a sufficient level of detail, e.g. the criterion of marketability is not considered so far.