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Joint trade associations' response to CEBS CP11

Technical aspects of the management of interest rate risk arising from non-trading activities and concentration risk under the supervisory review process

Key messages

We are pleased to have the opportunity to respond to CEBS CP 11 and believe that the section on Interest Rate Risk in the Banking Book is proportionate and grounded in the Basel Principles and the approaches our members already take, as it should be.

However we do not think that the material on Concentration Risk can have benefited from the same understanding of industry practice, as the results of the Questionnaire on Large Exposures – which could have been helpfully informative in the preparation of the Concentration Risk Principles – have yet to be analysed. We have not responded to the section of the paper on Concentration Risk in any great detail and recommend a delay of a few months before this work recommences in order that CEBS Concentration Risk Principles do take account of the work currently being undertaken.

We are also pleased to note that the consultation embodies the more principles based approach that the industry has been seeking, although we question the level of detail and tone of some of the language underpinning these principles. We are not convinced that the need for this further embellishment of the international standards has been fully justified.

We set out in more detail our comments below.

<u>INTEREST RATE RISK IN THE BANKING BOOK</u>

We entirely support the observation in the opening paragraph of Section 1 that institutions manage interest rate risk in the banking book (IRRBB) based on assumptions which are firm-specific. Management's knowledge of the relevant and material factors applying to their own firm-specific business model enables them to make the best judgement about the methods they use to manage IRRBB. There is no one approach which is universally appropriate and supervisors should not expect there to be one.

The Basel Committee on Banking Supervision's (BCBS) Principles for the Management and Supervision of Interest Rate Risk is an excellent starting point for the examination of this topic by regulators under the Supervisory Review and Evaluation Process (SREP). Our Members believe in a principles based approach to supervision and regulation and had welcomed the Basel document which acts as a strong influence for international convergence practices. It is therefore important, in order to avoid any potential for duplication or overlap or confusion, for any further guidance prepared by CEBS to articulate clearly what additional measures or clarification may be needed within the EU specific context. We are not, in the main, persuaded that CEBS has demonstrated that there is the potential need for further guidance to add value on this topic.

Current Market practices

Risk identification

The list of the ‘family’ of risks that contribute to IRRBB is comprehensive but is broadly a repetition of the four categories of IRRBB identified in the BCBS paper. We would prefer therefore for this section to use the accepted nomenclature;

- repricing or maturity mismatch risk
- basis risk
- yield curve risk
- option risk

and refer to the BCBS paper directly. Many of our members are active around the world so are as influenced by the BCBS Principles as they are by CEBS Guidelines. Introducing a potential re-interpretation of the Principles may require them to map their IRRBB risk management practices to two different but fundamentally similar documents for no added risk management benefit.

We recommend that this section be replaced with the four bullets above and direct reference to the BCBS Principles be made.

Monitoring and Management of IRRBB

This section accurately reflects the monitoring and management techniques used by our members, but does not consider the concept of proportionality. It is important to emphasise that not all institutions use all these techniques and the extent to which they do will be based on their own management’s assessment of the degree of IRRBB they actually face.

We therefore suggest the addition of a fourth bullet in paragraph 10:

- The choice of monitoring system and management technique used is determined by the banks’ management to be most appropriate depending on the nature, scale and complexity of their business

Variables monitored in the IRRBB process

It would be helpful to explain briefly why firms use the economic value perspective as a complement to the earnings perspective. The following amendment to the paragraph 18 text might be helpful:

18. The economic value perspective focuses on the sensitivity to interest rate changes of the market values of all interest rate bearing instruments. Economic value is the value of the discounted cash flows of assets minus liabilities, adjusted for off-balance sheet cash flows. *Some ~~Larger~~ institutions may use this approach as the shorter term earnings perspective will not completely capture the impact of interest rate movement on the market value of long term positions. This will have* ~~The changes in market values may in turn have~~ *an impact on net worth of the institution. For instance, negative changes in the ~~market~~ the economic value may indicate a future ~~values of all interest rate instruments~~* ~~give an indication of the potential~~ *deterioration of* ~~on future~~ *net interest income.*

Supervisory considerations

We agree that there should be no standardised reporting of IRRBB but recognise that our members must be able to calculate and report on the effects of the standard shock on economic value.

Any standardised report runs the risk of reporting on risks that for good reasons are not used or recognised by a firm’s senior management, failing the use test requirement and creating an extra regulatory burden.

Firms have developed bespoke methodologies for managing and reporting on IRRBB and we think that supervisors should be able to compare these with those of the firm’s peers in the SREP process, via examination of its ICAAP and discussion with management, rather than requiring a standard reporting format.

GUIDANCE FOR INSTITUTIONS

IRRBB 1

Methodologies

We welcome the explicit recognition that our members can use their own methodologies for measuring IRRBB. We also recognise that, if they wish, regulators can require an institution to apply an additional standardised methodology but hope that such requirements will be the exception, not the rule. All Pillar 2 techniques should be grounded in the way a firm actually runs its business. Imposing a standardised methodology cuts across this fundamental construct and should be resisted, even if its use would be convenient for a regulator.

Level of application

The level of application – solo, sub-consolidated or consolidated - is an issue for our members in many aspects of the CRD implementation. Although the Capital Requirements Directive (CRD) text sets legal constraints, the Pillar 2 process needs to be applied, as far as possible, only at the group level. Home supervisors’ efforts should focus on assembling information from all parts of the group to determine whether the individual legal entities are receiving the support - in this case in their management of

IRRBB - that is required. The supervisory process must be streamlined in a cross-border context as much as possible and requires appropriate regulatory cooperation to avoid duplication.

Exposure to IRRBB in different currencies

It should be recognised that a well-diversified global bank is sensitive to many different interest rates and that it is unlikely that all rates will move simultaneously in the same way. As such any standardised methodology should recognise this by including analysis of the risk by currency or by currency "block" so that the dependency on correlation/diversification can be assessed.

IRRBB 2

We recognise that the requirement to compute and report changes to their economic value as a result of a sudden interest rate shock is a CRD requirement arising from Article 124 (5). Our members will be able to comply with it and notify their home regulator order to discuss appropriate responses together.

The concept of economic value has not been further defined – an approach we support.

IRRBB 3

We agree that larger banks should assess other scenarios but believe that such scenario analysis and stress testing should be based on the firm's own assessment and assumptions about the impact of yield curve changes on its business and to choose the level of severity it wishes to apply. There is no one size fits all approach and a proportionate flexible approach is necessary.

IRRBB 4

We agree that the technical issues listed in IRRBB 4 are appropriate, subject to the principle of proportionality, for consideration by an institution. (We note that bullet 5 refers to pipeline risk which is an undefined term) However we are concerned that it looks too much like a tick-list. We hope that supervisors will not regard the list of technical issues as anything more than a guide to the sorts of issues they should be discussing with firms within the SREP. We would not expect firms to formally 'report' on all these issues but rather to take the relevant ones into account when considering the policies needed.

IRRBB 5

We support the use of standard interest rate shocks in each currency in which the firm has material interest rate risk. We believe the size of the shock should be based on the level of interest rates, with different shocks for different currencies if necessary. Shocks would be established by CEBS and reviewed regularly so that they remain relevant and do not introduce distortions because of differing regulatory interpretations of what a standard shock for a particular currency is. We believe that for non-eurozone currencies the standard shock should be determined by the regulator of the country of the currency concerned and adopted by CEBS. This will ensure that different standard shocks are not used by different regulators for the same currency, leading to a duplication of efforts by banks.

We suggest the standard shocks should be displayed on the CEBS website and subject to annual adjustment at the same time each year so that firms can be sure they are incorporating the correct standard shocks into their ICAAPs. If a review to cater for market developments takes place and results in changes to the standard shock this should be notified to the industry. In normal circumstances regulators should ensure firms have adequate notice of the introduction of new standard shocks. This notice period should be at least one month.

We suggest amendment of the bullet 4 so that if the required 200 basis point shock implies a negative interest rate the rate should be subject to a 0% floor.

IRRBB 6

We support the referencing of the Basel Principles in IRRBB 6.

IRRBB 7

We understand that the CRD gives supervisors the discretion to apply the SREP and therefore consideration of IRRBB at the level of the individual regulated firm but, to reflect general business practice and avoid duplication of effort, hope that this will be very much the exceptional approach – as careful reading of this Principle would seem to imply. It is our firm belief that Pillar 2 should apply at group level as this is the only way in which the home state regulator will get a holistic overview of the risks it faces.

IRRBB 8

We are unsure of the meaning of IRRBB 8 which is aimed at supervisors, but imposes an obligation on a firm - in the supporting paragraph - to undertake in depth analysis to facilitate the supervisors benchmarking. We think the supervisor undertake this work, based on the discussions it has had in the SREP. It is not reasonable to ask a firm to undertake analysis which is not part of its normal IRRBB management process.

We would prefer IRRBB 8 to be re-written as:

> **'Supervisors should understand the internal method used by an institution for calculating the economic value and, if requested, the amount of earnings, exposed to interest rate risk in the banking book, including any underlying assumptions (e.g. yield curves used, treatment of optionality)**.
>
> This will enable supervisors to undertake a comparative analysis of institutions which could form the basis for peer group analysis and/or (model) benchmarking.
>
> Institutions may be requested to calculate the effects of specific, ad hoc interest rate scenarios but supervisors should recognise that any requests should be reasonable and proportionate, taking into account the types and materiality of risks that the institution can reasonably be expected to be exposed.'

IRRBB 9

We support the recognition, implicit in the ordering of the first four bullets, that requiring a firm to hold more capital is the last of a number of options that regulators can take when deciding which supervisory measure to employ in response to a 20% or more decline in economic value following the application of the standard shock.

Supervisors should focus more on ensuring that risks are dealt with appropriately, engaging with the firm to determine whether appropriate strategies and mitigants are in place than on establishing that a firm has surplus capital or requiring it to hold more.

The list of elements that a supervisor may take into account in determining the choice of measure it could take is a fair one. We believe that reaching an understanding of a firm's approach to these elements is best achieved through dialogue with the firm as part of the SREP. Open discussion brings the ability to reach a greater mutual understanding and might actually remove the need for additional supervisory measures to be applied.

CONCENTRATION RISK

Key points

Timing

We agree with CEBS comments that the management of concentration risk is very important for firms; it is an issue for both on and off-balance-sheet transactions and for the trading book and non-trading book. We agree that concentration risk management is an integral part of firms' credit risk management process. We also agree that the degree of importance of concentration risk will vary depending on the nature of the firm concerned and that specialised institutions should not necessarily be regarded as more or less risky.

However, we do not believe that it is appropriate, at this time, to outline current market practice and develop detailed guidance on principles 1 to 5, without taking account of the results of the Industry Questionnaire that forms part of the CRD Large Exposures Review. We therefore do not propose to comment on the detail of the consultation paper and recommend that CEBS revisit the guidance in the light of what is learnt from the questionnaire exercise and defer this part of the consultation until Q4 of 2006. We recognise the implications for CEBS' timetable of such an action, but we consider that the timing of this consultation was already unfortunate, coming so late in the process. As CEBS has already acknowledged that CRD implementation will be an evolutionary process we think that it would be appropriate to delay.

Principles based approach

We are pleased to note that CEBS has taken a more principles based approach to this issue and welcome the move in this direction. We also consider that at a high level, principles 1 to 5 are appropriate and reasonable. Although, we recommend that the application of the supervisory principles should be risk based.

However we question the level of detailed guidance provided and in the tone in which it is expressed, which we consider will foster the 'box-ticking approach' that CEBS seems conscious to avoid, appears to add to the minimum requirements of the CRD and does not take account of materiality and proportionality.

Dovetail of Pillar 2 and the large exposures review

Our members consider that the large exposures review itself is vital because concentration risk management is important to firms, but also because of the divergence between current risk management practice and the regulatory requirements. We note that concentration risk is specifically identified in Pillar 2. We believe that Pillar 2 is an important aspect of developing overall regulatory thinking on concentration risk and therefore consider that it is essential that a holistic approach is taken in developing the forthcoming regime for large exposures. We recommend that any future regime should not only take account of the existing requirements in Pillar 2 but also that any guidance in that area should dovetail with any proposed large exposures regime.

June 2006