POSITION PAPER

ESBG response to the EBA consultation on the draft Guidelines on IRRBB and CSRBB

ESBG (European Savings and Retail Banking Group)

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ESBG

Dear Sir/Madam,

Thank you for the opportunity to comment on the European Banking Authority (EBA) consultation on the draft Guidelines on IRRBB and CSRBB. We would like to share the following reflections with you that we hope will be considered by the EBA.

General comments – Proportionality:

The EU framework for management of interest rate risk in the banking book has become very comprehensive and complex. Despite the legal basis for these documents being only two articles in the CRD (art 84 (5) and (6) and art 98 (5a)), the EBA is currently consulting on a total of 176 pages combined. In addition to this are the EBAs SREP guidelines, as well as guidelines and supervisory expectations from NCAs. In contrast, the Basel standard on which the framework is based is far less comprehensive and easier to understand. Also, the EU regulations apply to all banks whereas the Basel standards were initially developed for large internationally active institutions.

There is a general focus on ensuring proportionality in the prudential regulation. Although we acknowledge the need for sufficiently prudent management of interest rate risk amongst all EU/EEA banks, **ESBG believes the current framework is too complex and challenging to implement for smaller institutions with non-complex operations and limited market risk exposure.** Although there is a general possibility for institutions to, after a thorough and well-documented assessment, exclude certain risks if they can justify that those risks are not material, we believe there is a risk that supervisory practice will not be harmonized across the different jurisdictions. We hence believe that the guidelines and technical standards should provide more guidance on the application of the proportionality principle. This application should take into consideration the peculiarities of the national banking models and the interest risk inherent in national markets. In particular, small and non-complex institutions that are part of a group, subject to prudential requirement on consolidated level, should be excluded from the application of the strict thresholds for EVE.

Consultation paper on draft Guidelines on IRRBB and CSRBB

General comments:

The overall IRRBB framework has some components that receive large importance due to their relevance for many European banks, however, they are less critical or even marginal in certain jurisdictions. Inversely, the framework provides little guidance for other elements e.g. equity capital, or cross currency swaps. It should therefore be stated explicitly that the marked conditions across the EU/EEA differs (e.g. whether or not fixed or floating rate loans are most common) and that certain risks will be more or less relevant across different jurisdictions (and across institutions). The supervisory authorities should avoid an indiscriminate application of the framework, which would entail a disproportionate burden with little benefit for smaller institutions and for institutions in certain jurisdictions.

Moreover, the framework should avoid prescribing limit structures that are too rigid and thresholds that are too low in the SOT's for NII, as these would have implications for manoeuvrability. In article 114 it is stated that "Institutions should avoid […] that significantly reduce their capability to adjust to significant changes in the underlying economic and business environment." This article applies to the investment term assumptions for equity, but the principle should also apply to other parts of the framework.

With regards to CSRBB, banks have a large amount of freedom on how to incorporate this element in the overall IRRBB reporting. Hence, it might be useful to define a standard methodology on how this should be handled (sensitivity to a 1bp independently from correlation with other risk factors).

<u>Question 1</u>: In the context of the measurement of the impact of IRRBB under internal systems, paragraph 111 envisages a five year cap repricing maturity for retail and non-financial wholesale deposits without a specified maturity. Would you foresee any unintended consequence or undesirable effect from this behavioural assumption in particular on certain business models or specific activities? If this is the case, please kindly provide concrete examples of it.

N.A.

<u>Question 2</u>: Do respondents find that the criteria to identify non-satisfactory IRRBB internal models provide the minimum elements for supervisors' assessment?

As opposed to the desired outcome, the new version of the Guidelines sets very broad criteria to define "Non-satisfactory IRRBB internal systems", even with respect to the principle of proportionality. Our understanding is that the supervisory expectation is compliance with all requirements in the EBA guidelines. Failure to fulfil the supervisory expectations could imply that national authorities require the institution to use the standardized or simplified standardized method. NCAs are granted a substantial amount of discretion regarding the valuation of the institutions internal measurement systems (IMS) and leaves the possibility for large variations among and within jurisdictions.

The standardized approach is less granular than IMSs and assumes a static balance sheet. Requiring a bank to replace its IMS could potentially have a negative effect on risk management as it might no longer capture risks that are significant for the specific institution and put too much emphasis on others that are not. More risk sensitivity within the standardised approach may thus be envisaged.

To ensure good risk management practices and harmonized supervisory practices, ESBG therefore believes that this national discretion should be reduced through specific criteria that must be fulfilled for the NCAs to require this. Without a clear definition of what the individual authorities consider to be "material components of the interest rate risk (gap risk, basis risk, option risk)" and"robust and economically justified … dimensions of risks for significant assets", it is hard to create common definitions. A minimum requirement formulated as "In compliance with these Guidelines" (Article 118) is not very specific. Considering the limited ability of the standardised approach to adequately capture the exposure of each entity to IRRBB, acknowledged by the BIS in its 2016, any obligation by the supervisor should therefore be conditional on the competent authority having demonstrated that the standardized (resp. simplified) methodology would be more relevant than the IMS it would replace. For that purpose, the rationale behind a criterium – to be specified - for requiring an institution to use the standardized or simplified standardized approach must be that it improves the institutions risk management.

<u>Question 3</u>: Is there any specific element in the definition of CSRBB that is not clear enough for the required assessment and monitoring of CSRBB by institutions?

In general terms, it is not understandable that credit spreads, which are based on the existence of a market perception, are applied to illiquid and non-market instruments whose value doesn't change according to these market spreads.

More specifically, paragraphs 120a and 120b, but also paragraph 123, give the impression that the EBA GL follows in the spirit of BCBS IRRBB (2016/04), which discusses CSRBB explicitly for fail-value instruments, illustrated in Figure 1 in said document (BCBS IRRBB 2016/04). However, paragraph 124 in EBA GL on IRRBB & CSRBB explicitly says that institutions should not exclude any instruments in the banking book from the perimeter of CSRBB ex ante, including assets, liabilities, derivatives and other off-balance sheet items such as loan commitments, irrespective of their accounting treatment. This makes the definition of CSRBB very unclear, as it now includes i) amortized cost items, such as mortgages, and ii) items which in general, there is no clear market for (and therefore are not mark-to-market). It also is unclear on what grounds institutions can exclude items from the perimeter of CSRBB, as no such criteria is given. Rather, the implication is that everything which is considered banking book is also CSRBB, which goes against the spirit of BCBS 2016/04, where CSRBB was introduced. This is especially clear in paragraph 10 of BCBS; "CSRBB refers to any kind of asset/liability spread risk of credit-risky instruments that is not explained by IRRBB and by the expected credit/jump to default risk". **In this respect, we would like to receive a definition of the terms "market credit spread" and "market price of credit risk", which are stated in the paragraphs 120.a and 120.b for items that are accounted as amortized cost.**

Moreover, the scope of the CSRBB framework leaves some open questions with regards to specific instruments (e.g. in principle at least all FV instruments and own issued bonds). The consultation paper in fact envisages dramatic changes to the definition and scope of CSRBB while the July 2018 EBA Guideline already implemented the BCBS Standard that has not changed since then. The envisaged changes are not only not substantiated but they would also introduce significant confusions and complexities. The new framework creates the potential to include all fair value instruments on the banks' balance sheets and the banks are required to justify excluding any of these instruments. Even more so, paragraph 124 potentially includes all assets, liabilities and possible off-balance sheet items within the scope of CSRBB. It is unclear how items which are not traded (i.e., mortgages or deposits) could have a CSRBB component, hence the introduction of confusions and complexities. This puts an excessive operational burden on banks in terms of undertaking these evaluations and it allows for differences in interpretation and thus unharmonized practices across banks and jurisdictions.

<u>Question 4</u>: As to the suggested perimeter of items exposed to CSRBB, would you consider any specific conceptual or operational challenge to implement it?

ESBG believes that the presumption to include all items in the CSRBB framework is too extensive. Considering the theorical meaning of the credit spread, the CSRBB targets should focus exclusively on the market price of asset instruments, since only the market perception changes the credit spreads.

To avoid different interpretations and ensure a level playing field, it should be stated explicitly in the Guidelines that non-marketable instruments, e. g. loans to customers, should be generally exempted from CRSBB, as they are covered in the credit risk management framework of the bank. The scope should therefore be restricted to instruments that have a clear market price transparency and are easily tradable on a large and deep enough market, because only these kinds of market tradable assets are subject to such a market perception. Besides, within this group, we believe that the perimeter should not exceed the portfolios categorized as FVOCI and FVPL, insofar as they are the only ones with a regulatory obligation to be valued at fair value and therefore, the changes in the credit spread have a real and effective impact on equity value (is the case of FVOCI portfolio) and net interest income (is the case of FVPL portfolio). Changes in the credit spread of portfolios categorised at amortised cost have no impact on either equity value or net interest income, because the objective of the entity's business model is to hold the financial assets to collect the contractual cash flows (rather than to sell the instrument prior to its contractual maturity to realise its fair value changes)."

If this would not be the case, some specific conceptual challenges would arise: what would the rating be that would be assigned to deposits that are covered by the deposit guarantee fund? Or: Is there any evidence that the deposit's rates requested by customers is in line or fluctuating with the institution's rating? Is there any evidence that the loan's rates are in line or fluctuating with the spread curves, both in the short term and the long term? **Opening the scope of CSRBB beyond market-valued assets generates a plethora of casuistries, supported by theoretical concepts and without evidence of cause and effec**t.

An example of such a conceptual challenge could be the proposal to include items which are amortized cost as items which, by EBA paragraph 120.a, have "credit risk premiums required by market participants for a given credit quality", especially how such an instrument at amortized cost has a "market liquidity spread" that "represents the liquidity premium that sparks market appetite for investments and presence of willing buyers and sellers". This definition, given by paragraph 120.a and 120.b, would also need to be clarified for off-balance sheet items, such as loan commitments.

Additionally, due to the conceptual challenges, we would find the application of the CSRBB to all items CSRBB challenging to implement, also from an operational perspective.

Question 5: is the separation of IRRBB and CSRBB sufficient to understand where the Guidelines apply to:

- **IRRBB only**
- **CSRBB only**
- **both IRRBB and CSRBB?**

N.A.

About ESBG (European Savings and Retail Banking Group)

ESBG represents the locally focused European banking sector, helping savings and retail banks in 21 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 900 banks, which together employ more than 650,000 people driven to innovate at roughly 50,000 outlets. ESBG members have total assets of €5.3 trillion, provide €1 trillion in corporate loans (including to SMEs), and serve 150 million Europeans seeking retail banking services. ESBG members are committed to further unleash the promise of sustainable, responsible 21st century banking. Our transparency ID is 8765978796-80.

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