EBA/CP/2021/37
2 December 2021

# Consultation Paper

## Draft Guidelines issued on the basis of Article 84 (6) of Directive 2013/36/EU specifying aspects of the identification, evaluation, management and mitigation of the risks arising from potential changes in interest rates and of the assessment and monitoring of credit spread risk, of institutions' non-trading book activities

# 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 expressed / rationale 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.

**General remark:**

Promotional and public banks provide financial services and funding for projects that support sustainable economic and social development. They, typically, give their customers an alternative to capital markets that fail to price in the benefits of sustainable economic and social development to the community at large. They offer loans tailored for the needs of individual clients and commit long term to their clients. Consequently, the banking books of promotional and public banks also 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.

EAPB has the following general questions relating to the proposed guidelines on IRRBB and CSRBB.

- First and foremost, the requirements must not lead to bank individual, economic approaches being undermined so much that they are neglected. The resulting loss of expertise and experience would eventually have significant, negative consequences on the quality of institutions' IRRBB and CSRBB management.
- There should be no mandatory requirement of forward-looking EVE approaches: the use of a run-off assumptions should not be taken as a limitation. In contrast, it is the core of the EVE perspective. Unlike in the NII perspective, the entirety of future cash-flow is discounted which makes the two perspectives complements.
- The proposed criteria for non-satisfactory internal models need to be revisited. Some specific requirements should be dropped as they are disproportionate, especially for smaller banks, e.g. the inclusion of basis and option risks and the obligations with regard to model validation (in particular the isolation of effects resulting from behavioral assumptions or the analysis of elasticities).
- The requirements for the measurement and management of CSRBB are not only disproportionate but in parts even hardly feasible. In principle, we welcome the possibility to exclude certain positions from the respective requirements. However, we propose to
    - implement the possibility to exclude certain types of positions from the requirements in the first place (Ex ante negative list) – without the necessity of cumbersome verifications (e.g. loans to SMEs or private mortgages)
    - there might be positions that cannot be generally excluded for all institutions but are still not relevant to a material extent in individual cases. Thus, institutions should be given the possibility to perform individual materiality assessments and exclude further positions which turn out to be immaterial.
    - implement the possibility to exclude positions if the institution can demonstrate that the respective risk is already measured and managed elsewhere (e.g. in credit risk).
- Both EVE and NII approaches are used for the management of IRRBB in practice. However, usually one primary perspective is defined to be decisive in case of management conflicts.
- The possibility for each institution to make that decision should be maintained.

● We ask EBA to allow institutions sufficient time after publication of the final guidelines for the implementation of changes to the current guidelines.

● We ask EBA to explicitly state whether interest-sensitive assets covering an institution's equity must be included in the measures for IRRBB and CSRBB.

Referring to paragraph 83 and our general remark above, we ask EBA to clarify whether the principle of proportionality applies where institutions such as promotional and public banks set commercial margins that reflect their missions and not the interest rate environment.

Question 1: 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. We respond EBA with reference to Question 1 as follows.

The EAPB does not foresee consequences for its present portfolio, unintended or not, from the cap on the repricing maturity for non-maturity deposits.

Promotional banks offer public entities that are its core customers a deposit facility for operational purposes. They do not offer deposits to retail customers. Other deposits include deposits the bank holds with the central bank and collateral deposits. These all have short-term repricing maturities.

In a situation where a bank enters into a loan agreement with a wholesale customer requiring it to deposit the non-allocated funds with the bank, the five-year cap on the repricing maturity should not apply. It, especially, should not apply when the interest on the deposit is linked to that of the loan granted.

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

We respond EBA with reference to Question 2 as follows.

● We ask EBA to clarify how it can reconcile general "minimum elements for supervisors' assessment" with the principle of proportionality referred to in the proposed guidelines.

Paragraph 119(a), explicitly, considers the internal management system for managing IRRBB to be non-satisfactory if risk measures do not capture risk in an "economically justified manner."

● EAPB refers to its general remark, above, and asks EBA to clarify what constitutes an "economically justified manner." Economic concepts like 'fair value,' 'market prices,' and 'Economic Value' are not necessarily applicable to promotional banks.

Promotional and public banks provide financial services and funding for projects that support sustainable economic and social development. The banks offer those services and funding at a 'fair' price. 'Fair price' should not be confused with the accounting-concept of 'fair value' or economic concept of 'market value.' 'Fair value' and 'market value' are concepts based on the existence of sufficiently deep and liquid markets for instruments or close substitutes for such instruments. Frequently, such markets also fail to price in the benefits to society provided by promotional and public loans. Instruments for which no such markets or close substitutes exist make up upward of 90% of the banking books of promotional and public banks.

When a bank, in accordance with applicable generally accepted accounting principles, does not value assets and liabilities at fair value, EBA guidelines should not overrule such principles and impose a parallel fair-value administration. EAPB, consequently, expects its members to invoke the principle of proportionality to avoid the competent authority requiring the use of the 'standardised methodology.' The EAPB opposes the obligatory use of the 'standardised methodology' for being theoretical, inaccurate, burdensome, and prone to spurious risk measures.

Question 3: 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?
We respond EBA with reference to Question 3 as follows.

The definition of CSRBB relies heavily on the concept of 'market prices' for credit and liquidity risk. We ask EBA to provide examples of how to identify credit spread and liquidity spread components for instruments that do not trade in deep and liquid markets, and have no close substitutes traded in such markets.

Promotional and public banks, generally, set spreads that reflect the banks' missions and not the interest rate environment. As such, promotional and public banks may provide their customers protection against changes in the market prices of risk. Imposing a risk management system based on market pricing of liquidity and credit risk ignores this purpose of promotional and public banks. A promotional bank, further, can apply a funds transfer-pricing mechanism to mitigate changes in market prices of credit and liquidity risk it experiences in funding its lending activities. Paragraph 124 would prevent exclusion of such instruments.

- EAPB asks EBA to clarify how it should manage CSRBB where it is contrary to its purpose and business model.

- EAPB asks EBA to provide examples of how mitigating mechanisms such as funds transfer pricing may be considered in the measurement of CSRBB.

- EAPB asks EBA to clarify whether it should distinguish between liquidity and credit risk in its monitoring and management of CSRBB.

- EAPB asks EBA to clarify whether liquidity risk as part of CSRBB also extends to the cross-currency basis spread for currency swaps.

Question 4: As to the suggested perimeter of items exposed to CSRBB, would you consider any specific conceptual or operational challenge to implement it?
Promotional and public banks provide financial services and funding for projects that support sustainable economic and social development. They offers their customers an alternative to financial markets that fall to price in social benefits to the community in which they operate. Promotional and public banks commit to their customers for the long term.

In general, advanced banks use differentiated credit spread curves for fair value and credit spread risk calculations in a consistent manner, which consider not only currencies, but also sectors, products and regions. Often identical models are used for investment and trading books. Some credit spread risk models are already recognized as internal models for regulatory purposes

Moreover, liquidation of loans that fund projects that support sustainable economic and social development, generally, is undesirable. Consequently, many of the loans granted by these institutions do not trade in deep and liquid markets. Instruments for which no such markets or close substitutes exist can make up upward of 90% of the banking books of promotional and public banks.

Imposing principles of 'fair value' and 'market pricing' are contrary both to the mission of a promotional or public bank and the long-term commitment to its customers. CSRBB should not be a consideration for financial services and funding for projects that support sustainable economic and social development for the sole purpose of regulatory reporting. Paragraph 124 of the proposed guidelines prohibit institutions to exclude any instrument in the banking book from the perimeter of CSRBB ex ante. Institutions should document and justify the potential exclusion of instruments. For promotional and public banks, this would result in the requirement to document and justify exclusion for the larger part of instruments in their banking books. This would be unduly cumbersome.

The EBA proposes a generic credit spread curve for each rating category for CSRBB calculations only. Bonds of a rating category with observable prices must be selected for their derivation. In the absence of objective criteria, however, the selection of bonds is arbitrary and the derived credit spread premiums are not clearly determined. Instead, they depend on the proportion of sectors, products (e.g. covered bonds) and regions considered. For example, the EBA might answer to the question of which sector mix is right for the “true” credit spread premium (in practice this mix might even not be observable for each rating category). Ultimately, the subjective selection of the underlying issuers considered determines which idiosyncratic risks (and corresponding volatilities, correlations) are included in the credit spread risk calculation on average. Indices such as the iBoxx do not help either, because these also take into account an arbitrary (commercial) selection of issuers (in case of doubt, sovereigns dominate in a sector-free selection due to the high market capitalization). When using the iBoxx as a credit spread benchmark, the risk calculation would only be correct for those portfolios that exactly replicate the iBoxx. For all other portfolios, the risks are underestimated/overestimated, especially for fair value positions. This could also lead to an adverse portfolio selection, since in each rating category, from a risk/return perspective, the issuer would be taken that offers the highest credit spread premium (in case of doubt, an outlier issuer with the same rating but referring to a less stable region, sector, product).

Accordingly, an arbitrary selection of market-listed bonds for the generic credit spread curve per rating is already questionable for fair value positions, certainly not a suitable risk factor / model input for loans in the risk calculation. There is still no observable price nor a common market for loans.

EAPB does not consider the use of traded-bond indices a reasonable alternative for deriving market prices of credit-spread risk. Practically, we do not monitor these as they are irrelevant to the bank’s business. Unless yield data are readily available, it requires insight into the underlying portfolio and cash flows from it to derive yields and risk premiums. This would be a costly exercise that does not contribute to the business model. Furthermore, the use of indices compiled on ratings assigned by rating agencies ignores any criticism on past failure to capture credit deteriorations and the sticky nature of such ratings

We advocate that the existing CSRBB models with differentiated credit spread curves per currency, sector, product and region can continue to be used. The requirement that these models must always be conservative is hardly verifiable in practice, nor is it necessary, since the corresponding risk models have already been validated in terms of daily backtesting. On the other hand, a backtesting of the EBA approach does not seem possible due to the lack of reference to fair values.

● EAPB ask EBA to clarify how it will apply the principle of proportionality to promotional and public banks for which instruments that do not trade in deep, liquid markets and that have no close substitutes traded in such markets make up the larger part of their banking book.

EAPB further remarks that generally accepted accounting principle may require a bank to carry any derivative at fair value. Pricing theory for derivatives uses the possibility to hedge risks eliminating CSRBB in particular. Such instruments do not have a credit spread element and should be excluded ex-ante .

● The EAPB asks EBA to clarify whether article 124 extends to derivatives and to provides example of how to identify CSRBB for interest rate, currency, and credit risk derivatives.

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?

We respond EBA with reference to Question 5 as follows.

Paragraph 160 of the draft guidelines states 'diversification between CSRBB and IRRBB may be possible.'

● EAPB askS EBA to clarify whether institutions must manage IRRBB and CSRBB separately.
● EAPB asks EBA to provide an example of how institutions may consider diversification benefits.