



EBA/CP/2021/38
2 December 2021

Consultation Paper

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

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:

EAPB asks that EBA recognises promotional and public banks provide financial services and funding for projects that support sustainable economic and social development. They, typically, provide 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 will 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 observations relating to the draft Regulatory Technical Standards specifying standardised methodologies to evaluate IRRBB.

- The proposed standardised methodologies are not suitable for an appropriate identification, measurement and management of IRRBB.
- Only banks' own internal measurement methods, including the necessary expertise and risk measurement methods, can ensure that interest rate risks in the banking book are adequately reflected in a bank-specific manner.
- Therefore, banks should, if at all, only be obliged to apply the standardised approaches as a very last measure and the period of application should be limited as far as possible.

Consequently, there must also be no calculation of the SA for benchmarking purposes or whatsoever.

- **Regarding the preamble and slotting into maturity buckets:**

The preamble repeatedly refers to the slotting of cash flows in buckets. Preamble (9) suggest this facilitates institutions' implementation. The method is unlikely to align with institutions' administrations and inaccurate. Current IT solutions allow institution to generate accurate cash flow projections. Slotting those cash flows in artificial buckets would be costly and burdensome for institutions that implemented an accurate algorithm for discounting. We suggest EBA not to require slotting of cash flows into buckets if the institution uses a more accurate model for monitoring and managing its IRRBB. EBA might consider this as an option if the institution can show it cannot implement an accurate algorithm.

- **Regarding article 1:**

EAPB would like to point out that Article 1, paragraphs (5), (6), and (18) ignore instruments with hybrid interest rates that have a fixed 'risk-free component' until maturity, but a spread component adjusted at fixed times. We suggest EBA allows institutions to separately define repricing maturities for the 'risk-free component' and 'spread component' as far as such components are part of the measure for IRRBB.

- **Regarding article 3:**

EAPB requests EBA to further clarify Article 3, paragraph 1. Does the 5% threshold for a 'material' exposure apply only to the currency that surpasses the threshold, irrespective of the cumulative exposure of all currencies?

Article 3, paragraph 3 requires a re-calculation of the scheduled cash flow up to the repricing maturity to avoid gaps and double-counting in period NII. It may be expected a bank administers its due payments on loans granted. The method requires institutions to ignore their administrative payment schedules to create a fully fictional schedule of cash flows. This is unnecessarily burdensome.

- **Regarding article 4:**

The method of slotting cash flows in pre-defined buckets is unlikely to align with institutions' administrations and inaccurate. It is likely an institution's IT system that is capable of discounting cash flows will be better equipped to discount cash flows using the actual timing and corresponding discount rate. This would be contrary to the suggestion in preamble (9) this facilitates institutions' implementation. Slotting cash flows in artificial bucket would be costly and burdensome for institutions that implemented an accurate algorithm for discounting.

We suggest EBA not to require slotting of cash flows into buckets if the institution uses a more accurate model for monitoring and managing its IRRBB. EBA might consider this as an option if the institution can show it cannot implement an accurate algorithm.

Article 2, paragraph 1, requires inclusion of off-balance sheet instruments. In such case, the slotting of cash flows leads to spurious interest-rate sensitivity. A 10-year loan that has been granted forward in 10 years would be treated as a 20-year loan, when the sensitivity is that of a 10-year loan. It also results in applying the shock for a 20-year loan, when a 10-year interest-rate shock should be applied.

Article 1(1)(a) implies that a loan that only reprices the spread component of the coupon before the loan matures but not the risk-free component of the coupon reprices at the date the spread-component reprices. Subsequent application of article 4, paragraph 2 would result in underestimation of the interest rate risk, as the loan considered without a margin, or other spread component constitutes a fixed-rate loan.

- **Regarding article 6:**

We request EBA to clarify the term 'contractual agreement' used in Article 6, paragraph 1(b). The paragraph requires slotting of principal cash flows as per contractual agreement. It is not clear whether this is the contractual repricing date, as explicitly referred to in article 6, paragraph 1(a), or the contractual repayment date. The latter interpretation would require modelling of forward interest cash flows up to the instrument's maturity. This would be contrary to statement (9) in the preamble.

- **Regarding article 7:**

Article 7, paragraph 3 refers to article 7, paragraph 1, whereas the distinction between core and non-core deposits is given in article 7, paragraph 2, and does not extend to all types of deposits listed in paragraph 1. Should article 7, paragraph 3, not refer to article 7, paragraph 2?

- **Regarding article 8:**

The explanatory box following article 8 requires, in the case of retail loans and securitisations of loans that only allow prepayment at fixed moments in time, e.g., mortgage loans, to be slotted based on a model that ignores the characteristics of the securitisation. Consequently, it requires a bank that has modelled expected cash flows from such securitisations to develop a further model for

application of the standardised approach. This, again, makes the standardised approach a burdensome and costly method.

- **Regarding article 10:**

EAPB requests EBA to clarify what is meant by “the income and expenses deriving from the hedged position” in Article 10, paragraph 4.

- **Regarding article 11:**

EAPB requests EBA to confirm the title “other instruments” of Article 11 implies fixed-rate and floating-rate instruments, non-maturity deposits, including those subject to early redemption, and derivatives are not subject to optionality are not subject to the standards set by article 11?

- **Regarding article 12:**

EAPB requests EBA to clarify whether the relative increase in the implied volatility of the option only applies to the valuation of the option under the interest-shock scenario. If not, any hedge-relation will be broken, as article 12, paragraph 3 requires such for the offsetting option.

- **Regarding articles 14 and 15:**

Asymmetric treatment of hedge instruments and hedged instruments leads to spurious interest-rate sensitivity. When an institution hedges an embedded optionality with an automatic interest-rate option, it must carry the option at fair value. This is not necessarily the case for the hedged instrument with an embedded the explicit option hedges. Hedge-accounting allows for adjustment of the balance value of the hedged instrument by adjusting its book value to offset the fair-value change in the hedging instrument. Such does not constitute fair valuation of the hedged instrument. Hedge-accounting avoids volatility in book results that add to zero over the lifetime of the loan. This reflects the economic reality of the hedge.

Article 14 applies to options that mature up to the interest income horizon. The holder either exercises the option or not. If it does not exercise the option, it loses the option value at the start of the period, not the change in value from an instantaneous shock. At the same time, the hedged embedded option loses its value. It would exercise the option to offset the exercise of the hedged embedded option. Hedge accounting will reflect the offset to net interest income and other comprehensive income provided by the hedge.

Article 15 applies to options that mature after the interest income horizon. Hedge accounting allows institutions an offset to the value of the hedged instrument to reflect the hedge.

Articles 14 and 15 treat hedge instruments and hedged instruments asymmetrically.

- **Regarding article 17:**

Article 17, paragraph 2, requires calculation of forward rates. This appears contrary to preamble (9) stating “to facilitate institutions’ implementation, this Regulation should not require neither a calculation of the discount rate nor the risk free forward rate, for each repricing cash flow ...”

If an institution’s administration can accurately determine both the timing of a cash flow and the repricing tenure, the same calculation can be performed without the need for creating an artificial cash flow schedule and non-existent tenures based on midpoints of time buckets for the sole

purpose of applying a standardised calculation. It would require the development of an application for calculating numbers that provides the Bank's management with inaccurate, if not incorrect information. EBA might consider this as an option if the institution can show it cannot implement an accurate algorithm.

- **Regarding article 20:**

Article 20 treat hedge instruments and hedged instruments asymmetrically. Such asymmetric treatment of hedge instruments and hedged instruments results in spurious risk measures.

When an institution hedges IRRBB with an interest-rate derivative, it must carry the derivative at fair value. This is not necessarily the case for the hedged instrument. Hedge-accounting allows for adjustment of the balance value of the hedged instrument by adjusting its book value to offset the fair-value change in the hedging instrument. Such does not constitute fair valuation of the hedged instrument. Hedge-accounting avoids volatility in book results that add to zero over the lifetime of the hedged instrument. This reflects the economic reality of the hedge. It does so for the exact reason that the 'fair value' of an instrument tends to return to its face value at maturity' the explanatory box gives for limiting the calculation to instruments that mature beyond the horizon.

Article 20 requires institutions to calculate the change in the fair value of instruments up to the horizon. To do so, institutions must evaluate the forward rate at the horizon for each cash flow. Consequently, the slotting of cash flows up to the horizon into maturity buckets does not avoid the calculation forward rates for individual cash flows of instruments carried at fair value as suggested in preamble (9).

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?

We respond EBA with reference to Question 1 as follows.

Prepayment on floating-rate loans, typically, is possible without a penalty only when the benchmark index reprices. Consequently, the impact on EVE of prepayments on such instruments is negligible if at all existent. EAPB, therefore, does not see any need for a requirement in Article 6 for institutions to estimate prepayments for these instruments .

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.

We respond EBA with reference to Question 2 as follows.

- EAPB asks EBA to clarify the perimeter of article 7, paragraph 12.

Promotional and public banks provide financial services and funding for projects that support sustainable economic and social development. Such banks may primarily or even exclusively have non-financial customers. Deposits from such customers may mainly be wholesale deposits.

Banks may provide only non-maturity wholesale deposits for operational reasons to its customers that are, with few exceptions, non-financial. These deposits will be core to the bank's business model. The perimeter defined in article 7, paragraph 2, does not extend to such deposits. Consequently, article 7, paragraphs 3 to 11 would not apply to those deposits.

The single wholesale deposit for operational reasons to a financial customer, primarily, may serve as a credit-risk mitigation. Identification of stable, non-stable, core, or non-core element is irrelevant for the banks. Applying article 7 to this deposit would ignore its purpose, resulting in incorrect treatment of that particular wholesale deposit of a financial customer.

Article 7, paragraph 12 requires banks to identify non-maturity deposits as non-core deposits if they amount to less than 2% of relevant liabilities. Alternatively, if they amount to more than 2% of relevant liabilities, no such classification applies. Paragraph 12, however, is the only paragraph that does not explicitly excludes wholesale deposits of non-financial customers.

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.

We respond EBA with reference to Question 3 as follows.

Information technology allows for institutions to project cash flow schedules using actual maturities and tenures of instruments. The use of maturity and repricing buckets, likely, requires banks to implement a cash flow model for the sole purpose of performing the supervisory shock scenarios that is cumbersome, does not correspond to their administration, and is inaccurate.

- EAPB would like to draw EBA's attention to the possibility that prepayments may induce penalty payments compensating the issuer for the loss in economic value or interest income. Article 8, paragraph 5 does not consider this possibility. The unconditional bucketing of expected prepayments, therefore, could add an error to the aforementioned inaccuracy.

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

We respond EBA with reference to Question 4 as follows.

- banks' exposure to retail counterparties may be limited to indirect exposures as meant in article 8, paragraph 7. Behavioural options would include take-up rates on offered loans for which there is limited reason to expect significant sensitivity to interest-rate movements. Consequently, we do not expect this to be a relevant issue for banks.

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 respond EBA with reference to Question 5 as follows.

- EAPB requests EBA to clarify whether article 12 extends to embedded and explicit automatic options where the latter fully and effectively hedges the former; or, whether such hedged positions can be treated on a netted basis.

An Institution may hold or issue instruments that hold embedded options unique to the instrument. If the institution hedges the embedded option with an explicit option that may be unique and neither have a pricing history, nor have substitute for which the institution can observe prices. Unless institutions may net fully and effectively hedged automatic options embedded in their instruments with explicit options, article 12 would involve modelling options for which no data can be observed that allow institutions to derive implicit volatilities for the purpose of shocking these. Consequently, article 12 would not be 'operationally implementable.'

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?

We respond EBA with reference to Question 6 as follows.

- EAPB considers Article 13 not 'operationally implementable.'

Information technology allows for institutions to project cash flow schedules using actual maturities and tenures of instruments. Article 13 requires institutions to develop an artificial cash-flow schedule for the purpose of applying the standardised approach where it has in place a model that generates the exact schedule for cash flows. The slotting of cash flows into maturity buckets creates an inaccurate projection for the management of the Bank's liquidity position. The standardised approach would thus be unsuitable for internal management purposes. A preferable approach would be to build on the more accurate model if the institution has implemented such.

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)?

- It is the EAPB's opinion the determination of fair value components of NII results in spurious outcomes for NII sensitivity to IRRBB.

Promotional and public banks provide financial services and funding for projects that support sustainable economic and social development. 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 will hold loans for which there are no deep and liquid markets. Furthermore, commercial margins and spreads, generally, will reflect the banks' missions and not the interest rate environment.

Most accounting regimes require institutions to carry traded and over-the-counter (OTC) derivatives at 'fair value.' Promotional and public banks, by the nature of their business, may carry large parts of their assets and liabilities at amortised cost. They can hedge their exposures and apply hedge accounting to offset the change in the fair value of the hedging instrument. Hedge accounting does not reclassify the hedged instrument as 'fair value' instrument.

Article 20 requires institutions to calculate an add-on for instruments held at fair value. These include the hedge instruments, but, not necessarily, the hedged instruments. The asymmetric treatment of the hedge instrument and hedged instrument in articles 15 and 20 causes spurious outcomes for the NII measure of IRRBB.

In the explanatory box following article 20, EBA states 'Since the fair value of instruments tends to return to their face value at maturity, Article 20 only focuses on fair value instruments that mature beyond the horizon for the calculation of net interest income.' Hedge accounting allows institutions to adjust for that same characteristic of derivatives maturing beyond the horizon used to hedge instruments not carried at fair value.

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?
We respond EBA with reference to Question 8 as follows.

- EAPB considers the calculation of the net interest income add-on for basis risk not 'operationally implementable.'

In a concurrent consultation, EBA suggests the competent authority imposes a standardised approach on an institution that has an inadequate internal system for the management of IRRBB. EBA further imposes artificial slotting of cash flows into maturity buckets to facilitate calculations. Yet, EBA requires institutions that have an inadequate internal system for the management of IRRBB to be equipped to model conditional widening and narrowing of spreads between basic rates. The explanatory box, further, adds institutions should do so conditional on the interest rate environment without defining such.

A change in basic rates impacts the fair value of interest derivatives that mature beyond the horizon and are fair-value instruments. Asymmetric treatment of the hedge instrument and hedged instrument causes spurious outcomes for the NII measure of IRRBB.

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?

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?