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Mr. Jakob Lund
Mr. Toshio Tsuiki
Co-Chairs, Task Force on Interest Rate Risk in the Banking Book (TFIR)
Basel Committee on Banking Supervision (BCBS)
Centralbahnplatz 2
Basel, Switzerland

Re: BCBS Consultative Document on Interest Rate Risk in the Banking Book (IRRBB)

Dear Messrs. Lund and Tsuiki:

The American Bankers Association and the Securities Industry and Financial Markets Association (collectively, the Associations)[1] appreciate the opportunity to comment on the Basel Committee's consultative document (CD) Interest Rate Risk in the Banking Book (IRRBB). Interest rate risk is inherent to the role of banks as financial intermediaries. A bank that does not manage its interest rate risk can face diminished earnings, impaired liquidity and capital positions, and ultimately, greater risk of insolvency. Thus, we appreciate the need for strong interest rate risk measurement, monitoring, and management practices. However, it is important to get the measures of interest rate risk right. Otherwise, the measures will provide a misleading picture of interest rate risk, or worse, create adverse incentives for banks to manage to this inaccurate measure of interest rate risk and thereby *increase* risk. Unfortunately, the CD on IRRBB would do more harm than good.

We have significant concerns with the introduction of a Pillar 1 requirement and the proposed standardized elements of Pillar 2 to address interest rate risk. The underlying conceptual flaw in the proposed risk measures, their lack of accuracy, potential to mislead as well as other potential adverse incentives, and costs of implementation make a Pillar 1 capital requirement for interest rate risk inappropriate. Progress on techniques for measuring interest rate risk would be impeded by mandating prescribed risk measurement techniques that are not tailored to individual bank

[1] *The American Bankers Association is the voice of the nation's $16 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $12 trillion in deposits and extend more than $8 trillion in loans.*

SIFMA is the voice of the U.S. securities industry, representing the broker-dealers, banks and asset managers whose 889,000 employees provide access to the capital markets, raising over $2.4 trillion for businesses and municipalities in the U.S., serving clients with over $16 trillion in assets and managing more than $62 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

risk profiles, business models, or jurisdictions. The proposed Pillar 1 approach would impose a capital charge on opportunity costs and variability in earnings, even when the underlying economic value and earnings stream remains positive. Moreover, the diversity of institutions with different business models, asset-liability management strategies, and risk profiles shows that a one-size-fits-all approach—through a capital charge or supervisory framework—is not appropriate.

If adopted, the proposed Pillar 1 approach would represent a significant step backwards for interest rate risk management and risk management as a whole. Instead, we believe that a pure Pillar 2 approach relying on robust supervisory review, with some enhancements we suggest below, is the most effective way to encourage robust interest rate risk management and mitigation.

The U.S. banking sector has a long history of effective interest rate risk management that has been encouraged by strong supervisory oversight. The adequacy and effectiveness of a bank's interest rate risk management process and the level of its interest rate exposure are critical factors in the U.S. banking agencies' evaluation of the bank's capital adequacy. A bank with material weaknesses in its risk management process or high levels of exposure relative to its capital will be directed by the agencies to take corrective action. Such actions can include recommendations or directives to raise additional capital, strengthen management expertise, improve management information and measurement systems, reduce levels of exposure, or some combination thereof, depending on the facts and circumstances of the individual institution. More recently, severe interest rate risk shocks have been included into the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) process. As a result of the U.S. banking agencies supervisory approach, large U.S. banks are extremely well-positioned for sudden changes in rates.

The U.S. banking agencies' supervisory approach has been successful in part because of the flexibility built into the supervisory review process that considers factors such as the size of the bank, the nature and complexity of its activities, and the adequacy of its capital and earnings in relation to the bank's overall risk profile. In the early 1990s, the U.S. banking agencies considered developing a standardized measurement of interest rate risk for establishing an explicit capital requirement, but, following public comment and analysis and evaluation, concluded that the lack of accuracy, burden and potential adverse incentives and outcomes of implementing a standardized measure outweighed the potential benefits that such a measure would have provided. Only the Office of Thrift Supervision (OTS) developed standardized interest rate risk metrics (TB13 reporting). After the OTS was merged into the Office of the Comptroller of the Currency, the U.S. banking agencies discontinued the report as it failed to provide accurate measurements even for small banks with very simple balance sheets.

The U.S. experience is instructive for the Associations in evaluating the proposals in the CD on IRRBB, and leads us to recommend the following improvements to refine current supervisory approaches to interest rate risk:

- Banks should not be required to calculate or disclose the proposed Pillar 1 interest rate risk measures. We believe a standardized approach would be an inaccurate assessment of

interest rate risk, potentially could confuse and mislead the market, and pose a significant burden on the disclosing institution without accompanying benefits.

- Outlier tests should not be based on the proposed Pillar 1 measure. To the extent outlier tests are needed, they should be determined by national regulators as part of the supervisory process.
- References to credit spread risk should be removed from any final Pillar 2 standard. This concept is not well defined so it is unclear what would be required of banks.
- Internal IRRBB measurement, monitoring, and management approaches should be left to bank and subject to national supervisory review. Banks should be able to use models based on net interest income (NII), economic value of equity (EVE) or some combination that takes into account the specific products, markets, customers, and other characteristics of that bank's portfolio.
- The focus of a Pillar 2 approach should be only on the potential loss of capital and not variability of positive income.

With these changes, we believe the Basel Committee could develop a strong, effective Pillar 2 approach that would ensure banks appropriately manage their interest rate risk. These concerns and recommendations are discussed in further detail below.

- Section 1 outlines our concerns about the lack of accuracy of any uniform Pillar 1 measure of IRRBB and the potential adverse incentives that are created by an inaccurate measure.
- Section 2 discusses some of the deficiencies within the proposed Pillar 2 approach and offers recommendations to cure such deficiencies.

1. The proposed Pillar 1 approach is conceptually flawed and lacks accuracy, and any uniform measure of interest rate risk could not accurately reflect actual IRRBB given the diversity of bank business models and risk profiles.

The Associations have worked closely with the IIF/IBFed/GFMA/ISDA in developing a multi-jurisdictional industry comment letter and we are supportive of this letter. We would like to highlight in this letter several elements of the Pillar 1 approach that make it an inaccurate reflection of interest rate risk for U.S. banks.

A one-size-fits-all approach to IRRBB cannot reflect an individual bank's actual levels of interest rate risk because IRRBB is so dependent on the specific bank's product offerings, market and regulatory environments, business models and customers' behavior. This results in justifiably heterogeneous assumptions, monitoring and measurement techniques, and risk management. Hence, a standardized approach simply cannot cater to the diversity of products and risks inherent in IRRBB. Reliance on any uniform Pillar 1 measure could very well lead to misleading and irrelevant considerations and recommendations for IRRBB management, as well as IRRBB regulation.

While we acknowledge that the CD includes limited flexibility for non-maturity deposits (NMDs) and supervisory discretion to allow firms to establish baseline scenarios for other positions with behavioral options, the proposed categorization, fixed parameters, caps, and floors

involved in attempting to standardize these positions are simply not reflective of the diversity banks face in practice. It will therefore lead to under- or over-estimation of risk.

The following areas contribute significantly to the lack of accuracy of the proposed standardized approach:

- **Basing a capital charge on variability of positive income is conceptually flawed.** The proposed Pillar 1 approach would assign a minimum capital charge on the basis of opportunity costs and fluctuations in potential earnings. These measures are more applicable to the risks faced in the trading book. The CD fails to consider the intrinsic differences between the banking and trading books.

  While variability risk is an appropriate measure in the trading book, a banking book capital requirement should be based on the risk of loss to capital. There is no need to impose a capital charge for assets held in the banking book when the underlying economic value and earnings stream remains positive.

  Banks should and do consider variability and volatility as part of the internal risk management analysis, and such considerations are an important part of the supervisory process. But these considerations are more appropriate as part of the internal risk management and Pillar 2 supervisory processes—not an explicit Pillar 1 capital charge.

- **The Committee should not specify a specific modeling approach**. There are a number of basic foundational approaches to measuring interest rate risk. Each one has benefits and drawbacks. Specifying any single approach (whether EVE, MVE, or NII) is inappropriate because one method may be more appropriate for a particular bank's products, customers, markets, and other characteristics.

- **The proposed approach to NII is simplistic and static.** We also note that the proposed earnings at risk (EAR) approach for NII views a bank's balance sheet as static. In reality, banks constantly adjust their balance sheets as assets mature, liabilities run-off, and new assets and liabilities are created.[2] The Pillar 1 approach is inconsistent with our view that IRRBB EAR measures are best implemented on a dynamic forward-looking basis.

- **The restrictions and categorizations on non-maturity deposits is a fundamental flaw**. The proposed treatment of NMDs is far too restrictive and does not realistically represent the interest rate sensitivity of deposits because it only recognizes limited categories of

[2] For example, for retail non-maturity deposits (NMDs), the proposed static NII approach without consideration of future deposit volumes would inaccurately estimate the interest rate risk, because new non-maturity deposits do not come on the books at the prevailing market rates, or put differently, these deposits do not reprice at market rates. The proposed approach mistakenly reprices all new deposits (beyond the balance attrition from its EVE framework) at full market rates. Additionally, the static nature of cashflows in the proposed NII approach fails to capture any convexity in the balance sheet.

deposits,[3] makes inaccurate assumptions regarding cash flows, and has standardized pass-through rate, stability, maturity, and weighted average life (WAL) parameters.[4] While the proposed parameters and cash flow assumptions may accurately reflect the percentage of stable, core deposits at a certain point in time for a certain bank, they would significantly over- or under-estimate the percentage of stable, core deposits at other banks, or even same bank, in a different jurisdiction, or a different point in time. Given the diversity of products in different jurisdictions, a one-size-fits-all approach simply does not work.

Large U.S. banks have empirical models to estimate balance and rate behavior of NMD for interest rate risk measurements. These models are calibrated with each bank's internal historical data and reflect characteristics specific to the products offered by the bank, behavioral characteristics of its customers, pricing strategy, competitive factors in its footprint, the interest rate environment and lending opportunities. These models are independently validated and monitored by independent second lines of defense. U.S. supervisors closely review these deposit models in both interest rate risk measurement and CCAR contexts.

Given its simplified and standardized nature to accommodate a global application, the proposed Pillar 1 approach will not reflect banks' specific deposit portfolio characteristics (let alone completely different deposit products across different jurisdictions), and hence its actual levels of interest rate risk. A uniform measure would lead to misinformed and wrongly-placed considerations and recommendations for banks' IRRBB management, including hedging decisions. Banks offer different types of deposit

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[3] We particularly note the proposed NMD categories recognize transactional retail deposits but not transactional wholesale deposits. Like transactional retail deposits, wholesale deposits also have a stable, transactional component. For example, custody and trust banks receive customer deposits as a by-product of the operational services they provide. The Basel Committee specifically recognized these stable transactional wholesale deposits as "operational" deposits in the Liquidity Coverage Ratio (LCR). Like transactional retail deposits, operational deposits are not interest-bearing or have lower-than-market rates. Operational deposits are also subject to numerous other stringent criteria to ensure their stability, as detailed in the LCR.

The proposed stability caps, pass through floors, cash flow slots, and time series approach for NMDs are rudimentary, overly constraining, and do not reflect this observed behavior for wholesale transactional deposits. The proposal effectively imposes a 33% limit on the amount of wholesale deposits that can be considered "core." This estimate is overly conservative and inconsistent with historical experience. It will be even more so once the U.S. interest rate environment normalizes and excess deposits potentially leave the banking system.

[4] In particular, transactional accounts characterized as demand deposit accounts in the U.S. are often non-interest bearing. Accordingly, the pass-through rate is by definition 0%, whereas the CD imposes a 25% floor for transactional accounts in its global application. The standardized global WAL assumptions are also capped effectively at 2.4 years for retail transactional (3 yr x 80% stability cap) and 2.1 years for retail non-transactional (3yr x 70%). In the U.S., the effective WAL of deposits is meaningfully longer than what is implied by the imposed caps. We expect that the combination of stability, WAL, and pass-through floors/caps would result in over 5-years misestimate of the duration of equity (DOE).

products; therefore, applying a one-size-fits-all treatment to all NMDs across all countries runs counter to how banks manage NMDs.

- **Applying standardized multipliers to baseline prepayment rates is inappropriate.** The standardized multipliers to the baseline conditional prepayment rate for fixed rate loans are completely at odds with expected prepayment rates with no directional bias, i.e., depending on the level of rate incentives, standardized prepayment rates alternatively overestimate or underestimate a bank's expected prepayment rates. This issue may be exacerbated in the U.S. where, unlike many other jurisdictions, mortgage borrowers have 30-year fixed rate loans that may be prepaid without penalty. Given that this customer optionality exists, large U.S. banks have sophisticated models to predict prepayment behavior across interest rate and economic scenarios. Building restrictive assumptions into the Pillar 1 approach relevant to behavioral interest rate-sensitive optionalities, such as prepayments, is nearly impossible to do across markets where borrowers have different options. We also note that for fixed rate loan commitments, the proposed methodology leads to the extreme outcomes of 100% or 0% drawdown and also suggests an unrealistic scenario that a significant portion of loan commitments would be drawn down overnight for a "Parallel Up" shock.

- **The implied zero duration of equity assumption is overly simplistic.** By using an EVE framework, the CD implicitly creates a zero risk point at a zero duration of equity. The assumption of zero duration of equity in the CD is in contrast to banks' actual investment duration of equity, and will be a key driver of the proposed IRRBB measure and associated capital charge. This assumption implies that a "neutral" interest rate risk profile would correspond to investing net cashflows (net of assets and liabilities) to overnight assets. Such an investment approach would result in significant earnings volatility. However, to facilitate effective risk management, many U.S. banks apply a safe-harbor duration to equity, typically two to five years, in order to balance the trade-off between optimal duration of equity and earnings stability that cannot be simultaneously hedged, as recognized on page 2 of the CP. This assumption has the potential to create implicit incentives for banks to manage toward a zero duration of equity as measured by the flawed one size fits all approach. Banks that do this would in effect be increasing their interest rate risk. Permitting banks to apply their defined investment of equity in accordance with risk appetite, and having this duration appropriately embedded in the risk management framework, is important for effective management and measurement of IRRBB and well managed earnings volatility.

- **The approach to designing shock scenarios is flawed**. The proposed methodology in the CD in designing shock scenarios does not take into account local volatility but instead mixes up different curves in different currencies to arrive at a set of standardized global shock parameters. As a result, the scenarios do not reflect the relative levels of volatility in different currencies. The proposed stress scenarios will therefore likely underestimate risk in some jurisdictions and overestimate risk in others.

These numerous and fundamental flaws of the proposed Pillar 1 approach to IRRBB have led us to conclude that the standard is unfit for either a minimum capital requirement or as a disclosure or outlier regime that would accompany a Pillar 2 framework. If adopted, the standard would represent a significant step backwards for interest rate risk management and risk management as a whole.

2. The Associations support a pure pillar 2 approach

The CD contains two alternative approaches, Pillar 1 and Pillar 2. However both approaches are heavily dependent on a uniform, Pillar 1 approach to IRRBB. The proposed Pillar 2 approach requires the public disclosure of the outcome of the proposed Pillar 1 calculation approaches together with a requirement for supervisors to use the Pillar 1 framework as a comparison metric (benchmark) and fallback approach. We believe that the proposed Pillar 2 approach would constrain banks' internal modelling of IRRBB and likely establish a floor to the capital banks should hold. We encourage the Committee to develop a pure Pillar 2 approach.

We make the following recommendations for a revised Pillar 2 approach:

A) An appropriate Pillar 2 framework should focus on risk management, governance, and a strong supervisory process.

For over a decade, U.S. banks have implemented a strong risk and capital management framework, with vigorous supervisory oversight by the responsible regulatory agencies. The calculation of Economic Capital (EC) using the Internal Capital Adequacy Assessment Process (ICAAP), a mandatory component of the current Pillar 2, includes processes for identifying, measuring, monitoring and reporting of risk, the establishment of policies, procedures, limits and controls, a strong internal controls framework across the risk and capital management processes, and oversight by the Board of Directors and senior management. This oversight includes the approval of risk appetite statements, and the monitoring and measuring of risk taking activities against approved risk appetites. Pillar 2 therefore provides the appropriate risk and capital management standards for managing IRRBB.

Under the current U.S. Pillar 2 approach, the adequacy and effectiveness of a bank's interest rate risk management process and the level of its interest rate exposure are critical factors in the agencies' evaluation of the bank's capital adequacy. A bank with material weaknesses in its risk management process or high levels of exposure relative to its capital will be directed by the U.S. banking agencies to take corrective action. Such actions can include recommendations or directives to raise additional capital, strengthen management expertise, improve management information and measurement systems, reduce levels of exposure, or some combination thereof, depending on the facts and circumstances of the individual institution.

Importantly, the decision about whether corrective action is necessary is generally made by examiners who are extremely knowledgeable about an institution. This means each banks' evaluation includes factors such as the size of the bank, the nature and complexity of its activities, and the adequacy of its capital and earnings in relation to the bank's overall risk profile. Banks are given full flexibility to use internal measurement systems, subject to

supervisory approval and on-going review. Instead of mandating one modeling approach over another, U.S. regulators have established IRRBB expectations that are tailored for each institution.

We encourage the Basel Committee to adopt a pure Pillar 2 approach. A Pillar 2 framework, with a strong supervisory process, provides the appropriate risk and capital management standards for managing IRRBB.

B) A pure Pillar 2 framework should not require allocation of capital for an isolated IRRBB measure, and especially not one that focuses on variability risk.

Pillar 2 has always required a bank to calculate economic capital and evaluate its capital adequacy against all of its economic risks. However, Principle 9 in the CD appears to go farther by requiring a bank to calculate and allocate economic capital for IRRBB as a separate, additive category, rather than as part of a broader calculation of economic capital for risk (e.g., that could include trading market risk and IRRBB).

We believe this is inappropriate and ignores the fundamental interplay and diversification of different types of risk. Presumably, even if a bank had a separate category of economic capital for IRRBB, its calculation would take into account the bank's assumptions of cross risk diversification.

We note that the separate allocation of capital for IRRBB is especially problematic because of the focus on income variability. Banks do evaluate fluctuations in income for IRRBB on a standalone basis for management purposes as well as part of comprehensive scenario analysis for risk management purposes. IRRBB is evaluated in capital planning exercises (e.g. stress testing) where the variability manifests itself and is incorporated into the adequacy of internal capital buffers for capital management purposes. With this approach, while capital is not directly allocated specifically to IRRBB, the potential loss over a stated horizon due to variability is considered when developing internal capital allocations.

C) A pure Pillar 2 framework should not require calculation or disclosure of uniform interest rate risk measures.

The proposed Pillar 2 framework requires banks to calculate Pillar 1 measures for disclosures and the Standardized Outlier Test (SOT). Any calculation or disclosure of uniform, Pillar 1 measures is misguided.

Public disclosure of the proposed Pillar 1 calculations would be misleading because they are fundamentally inaccurate for reasons we already cite above. Moreover, as the proposed quantification fails to reflect differences among banks, any comparisons between banks would be misleading.

The additional operational cost in terms of infrastructure investments needed to conduct and report the Pillar 1 calculations cannot be justified as there is no benefit either to banks' internal

risk management or to the understanding of banks' IRRBB exposure by supervisors and other stakeholders.

Similarly, we oppose the inclusion of any required SOT based on Pillar 1. We acknowledge the usefulness of an outlier test for jurisdictions with less robust supervisory processes. However, we believe that U.S. regulators already have all the information and expertise needed to monitor interest rate risk at internationally active U.S. banks. The outlier test is therefore simply unnecessary in jurisdictions with a strong supervisory approach. As a result, the Basel Committee should encourage national regulators to develop local outlier tests as needed.

D) Disclosures based on internal measures should be limited under a pure Pillar 2 framework.

Even if measured using internal models, information regarding the impact of hypothetical interest rate scenarios should not be disclosed. The results would not be meaningful to a user without detailed proprietary information.[5] Due to the proprietary nature of key bank assumptions in projecting their interest rate risk, we believe the results within the Pillar 2 framework should be reported to supervisors who have an appropriate understanding of a reporting bank's modeling approaches. This information could be used by supervisors to conduct a thoughtful assessment of a bank's exposure to interest rate risk and facilitate peer comparison.

E) Banks should be permitted flexibility when trying to capture the vague concept of credit spread risk in the banking book.

The IRRBB consultative document includes a vague concept of credit spread risk in the banking book (CSRBB). It is unclear whether CSRBB is part of IRRBB or a separate concept. It is also unclear what the scope of CSRBB would be. To the extent the Basel Committee seeks to include CSRBB in the Pillar 2 approach, the Associations urge flexibility for each bank to determine CSRBB based on its own profile and subject to robust supervision, consistent with a pure Pillar 2 approach.

F) National regulators should be afforded flexibility in developing scenario details.

A limited amount of standardization in a Pillar 2 approach could be beneficial to promote comparability. For example, to ensure Basel Committee member states are appropriately applying a Pillar 2 framework, the Committee could consider developing general parameters for the shock scenarios used in a Pillar 2 framework. For example, these general parameters could include the number of shock scenarios, the time horizon for IRRBB to be measured, the confidence level, and general shapes (parallel, steepeners and flatteners). Within these parameters, national regulators could then develop appropriate scenarios that reflect specific characteristics of their markets in their jurisdictions based on their country specific interest rate data.

[5] Such proprietary information may include assumptions regarding loan growth and loan renewals, changes in product mix, investment portfolio rebalancing, and optionality estimates. We are also particularly concerned about disclosures related to deposits. The CD appears to require disclosure of expectations of deposit business strategies and depositor behavior.

Thank you for considering the concerns and recommendations raised in this letter. If you have any questions or need further information, please contact Hugh C. Carney, Vice President of Capital Policy, American Bankers Association at 202-663-5324 (email: hcarney@aba.com) or Carter McDowell, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association at 202-962-7327 (email: cmcdowell@sifma.org).

Respectfully Submitted,

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