Consultation response

Revision of the guidelines on technical aspects of the management of interest rate risk arising from non trading activities

27 September 2013

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the consultation on the *Revision of the 'guidelines on technical aspects of the management of interest rate risk arising from non trading activities in the context of the supervisory review process' from 3 October 2006, under Articles 123, 124 and Annex 5 of Directive 2006/48/EC of the European Parliament and the European Council* (EBA/CP/2013/23). AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

Over-arching comments

We note that the treatment of interest rate risk in the banking book is an issue that is under consideration by the Basel Committee. Care should be taken to ensure that any developments on this topic in the EU do not front-run the consideration of the issue globally. The EU should not proceed unilaterally with any new approaches in this area.

Responses to questions

Question 3

Do you agree that an average duration of 5 years is appropriate for the behavioural assumption for non-maturity liabilities when calculating the effects of the standard shock? If not, what duration and/or measure would you suggest instead? Should the volatile portion be included in the average, or just the stable core?

We do not agree that such a model constraint should be introduced. A five-year average duration is arbitrary and will not lead to valid comparisons. We strongly believe that banks should use the same assumptions in internal steering/reporting and external (stress test) reporting when estimating client behaviour and calculate the impact if the assumptions are put under stress. If customer behaviour and/or product features lead to longer average durations this IRR (interest rate risk) profile should be used (given regular validation, clear governance and so on). We believe that a comparison based on an incorrect approach is misleading and should not be made.

Furthermore, a cap could adversely impact the treatment and internal management of positions which might lead to incorrect prices of products and a distortion of the funding side of the credit business.

Question 4

Should the calculation of the level of the economic value use a risk free yield curve that excludes instrument or entity specific credit risk spreads and/or liquidity risk, or should assets and liabilities be valued using an institution-specific credit risk curve? Should the calculation of the net interest income consider the change of the credit spread of assets and liabilities for the repricing of instruments that maturate?

IRR should be calculated based upon the relevant yield curve for the specific underlying. Bonds in the Banking Book should, therefore, be discounted using the relevant credit spread curves. Retail products on the other hand, where market spreads are neither well observable nor tradable, should be discounted with discount curves chosen by the institution deemed relevant for the underlying product.

We believe that including own credit spreads for self-issued bonds is appropriate from a pure PV01 measurement perspective. For deposits, own credit spreads should be excluded when calculating PV01.

For net interest income forecasts, we believe that credit spread components should be included as well as credit risk costs.

Question 14

Do you agree that institutions should monitor both risk to earnings and risk to economic value?

Earnings at risk calculations are and should be part of any business planning process. However, it should not be mandated as a good measure for IRR as it is heavily dependent on applied parameters such as interest rate, future margin, time horizon scenarios. Institutions should typically focus on economic values when dealing with IRR (PV01 measurement, stress tests on economic value, ICAAP).

Question 22

Do you agree that institutions should allocate internal capital against potential future earnings at risk, based on the result of their stress-testing?

No. Allocation of capital should be consistent with the ICAAP approach of the institution: if this focuses on the economic value, internal capital and limits should be in line with this. In any case, double counting of risk needs to be avoided by restricting capital allocation to earnings risk which originates from sources other than position taking (for example strategic or reputational risks).