Interest rate risk in the banking book

BSA response to Basel Committee consultation

10 September 2015

Building Societies Association

Introduction

The Building Societies Association provides this brief response to the BCBS consultation. The BSA's members, the 44 UK building societies, all experience interest rate risk in the banking book (IRRBB,) though none is a "Basel bank" – i.e. a large, internationally-active bank. Our concern is that the finalised Basel proposals, when rolled out to domestic entities, will prove over-complex and unsuitable for, in particular, our smaller members, and as a result will have anti-competitive effect.

The BSA belongs to the European Association of Co-operative Banks, and our experts have contributed to the EACB's internal work leading up to its comprehensive response to the CP. We support the EACB response, and highlight in this BSA response only a few key points of particular relevance to our members.

The BSA agrees that interest rate risk is an important part of the overall set of financial risks our members have to manage, and a review of the capital treatment may well be timely. Since our members do not run trading books, this risk is entirely contained in the banking book – and there is no arbitrage possibility as mentioned in the CP. The question is not whether IRRBB should be adequately reflected in capital requirements, but only whether that should be done more appropriately under Pillar 1 or (as at present) under Pillar 2.

In principle, we have an open mind, and are fully aware of the reasons for aiming for a Pillar 1 treatment where possible. In some areas, a sufficiently simple Pillar 1 treatment can work well for small institutions. **Overall, however, the BSA concludes that retaining the Pillar 2 approach works better, especially for our members, than having to apply these Basel Pillar 1 proposals. We agree with the EACB's key message on this.**

Moreover, in the context of the Pillar 2 option, we also agree with the EACB's challenge that the disclosure proposals go too far. One of our leading members has raised two concerns. First, on the burden (on top of maintaining a full Pillar 2 methodology) of also having to make, and then disclose under Pillar 3, the results of applying a standardised Pillar 1 assessment of IRRBB. The economic and behavioural impact of this could be similar to, and as damaging as, the direct imposition of a Pillar 1 regime – mandating the disclosure of standardised Pillar 1 results comes close to imposing a Pillar 1 regime by the back door – and for that reason is opposed. The premise of the Pillar 2 option is that IRRBB is not after all suitable for Pillar 1 treatment, so why mandate disclosure of an unsuitable calculation? Second, the disclosure goes into matters such as the assumptions behind NII measures, which might include commercially and competitively sensitive matters such as loan prepayment rates, redemption ratios, and the corresponding impact on earnings. This is one aspect of Principle 8 - see below - that should be challenged.

General observations

The principal drawbacks of the Basel Pillar 1 proposals are their **complexity**, and the over-conservative treatment of **non-maturity deposits** (NMDs). We support the EACB's analysis on both these points.

On **complexity**, the problem arises from the application of a methodology designed for "Basel banks" to a much wider scope of institution, especially in the EU. The track record to date is that Basel rules are rolled out far wider than the intended scope of "Basel banks". Where the Basel rules include a simpler standardised alternative that may not be too much of a problem. But the Pillar 1 IRRBB proposals are far from simple. Their very complexity creates an unnecessary burden for smaller banks, which (as with all regulatory complexity) has anti-competitive effect.

As one of our leading members has commented, a one size fits all standardised approach created with the interests of large global systemically important institutions (G-SIIs) will always cause significant problems for small locally based mutual building societies, and this is particularly the case with IRRBB. The Basel Committee acknowledges that the drive to implement changes to IRRBB has come from the need to stop large banks including G-SIIs from gaming the current system. But in the process of reducing those systemic risks, the Basel Committee's approach could serve only to disadvantage those that do not game the system, and which pose minimal systemic risk. Is that an acceptable outcome?

Building societies are generally able to limit the level of interest rate risk they are exposed to through natural hedges across the balance sheet. However, this only works where there is flexibility within limits. If capital is charged against the level of limit held or exposure it is less likely that such natural hedges will be adopted and in their place firms will look to greater use of derivative markets which will increase costs and liquidity risks associated with collateral requirements.

From the building society perspective, one of our members has raised the following particular challenge to using the economic value test, constructed out of the management of trading activity, to ultimately determine capital requirements. Economic value measures have their place but economic value is of secondary importance to a mutual building society; no building society currently operates a trading book but all are fundamentally focused on the margin between the mortgages they lend and the rate paid to savings customers which, by law, represent the primary source of funding. The UK regulator currently applies a simple but effective approach to assessing gaps and applying a standardised interest rate shock to cash flows. However, the approach being consulted upon is unnecessarily complicated in the way in which it deals with optionality and NMDs. If an instrument has such sophisticated optionality that it requires the level of stress testing sophistication being proposed - it would perhaps imply that the instrument does not deserve to be in the banking book and is more amenable to a trading book treatment which would result in fundamental misalignment of the capital provision with retail customer behaviours.

Non-maturity deposits are an extremely important and stable part of the funding base of building societies, like many co-operative banks, and will often be the single most important

component of any IRRBB calculation – so imposition of inappropriate yardsticks makes a big difference to whether the whole Pillar 1 approach is workable for our members or not. We agree with EACB that the Pillar 1 proposals are excessively conservative for no good reason.

Again, one of our leading members has made the following point : a particular issue for building societies is the treatment of reserves. If, as proposed, through the use of an EVE measure, the reserves are ignored, this would leave a large fixed rate asset position with respect to the hedge, particularly where the assets funded are of a greater duration. In order to avoid the capital charge associated with the hedge of the reserves position, firms may elect not to hedge which would result in an increase in income volatility. Perversely, if hedging reserves, as capital increases, the risk position as viewed by the proposed approach will also increase, and firms will have to increase their capital to cover that increased capital. This issue could be easily mitigated by including a reserves duration within the approach. To stop firms gaming interest rates through frequent changes to their target duration, this should be set at Board level with all material changes taken through the same governance process

There is also one **practical** point - a number of the larger building societies have access to the more sophisticated approaches to assessing IRRBB including NII modelling. However, even when this is the case, forcing those societies to re-engineer their models into the coarse time buckets proposed within the consultation will cause a great deal of re-work and is unlikely to yield satisfactory reconciliations with current output. At best this will drive up costs (from the additional monthly burden placed upon the firms), at worst some firms may decide that they cannot support both approaches and drop the more sophisticated internal/3rd party models. So the result could be a levelling down of risk management.

The **Principles** outlined in Section III of the CP are (for the most part) a reasonable framework – we have only two comments. First, to stress the importance – especially whenever Basel rules end up rolled out beyond "Basel banks" to smaller, simpler institutions – of the overriding **Proportionality Principle** at paragraph 2.3 on page 28. Second, as mentioned above, we have reservations about the ramifications of **Principle 8** which stray into areas of commercial and competitive confidentiality.

Finally, it should go without saying that if IRRBB is in the end to be covered under Pillar 1, there must be a commensurate reduction in the Pillar 2 charge – otherwise there will be double counting.

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The Building Societies Association (BSA) is the voice of the UK's building societies.

We fulfil two key roles. We provide our members with information to help them run their businesses. We also represent their interests to audiences including the Financial Conduct Authority, Prudential Regulation Authority and other regulators, the government and parliament, the Bank of England, the media and other opinion formers, and the general public.

Our members have total assets of over £330 billion, and account for approximately 20% of both the UK mortgage and savings markets