Australian Banking Association

29 May 2023

Mr
General Manager, Policy
Australian Prudential Regulation Authority

By email: ADIPolicy@apra.gov.au

Dear Mr

Interest Rate Risk in the Banking Book

The Australian Banking Association (**ABA**) welcomes Australia Prudential Regulation Authority's (**APRA**) ongoing and constructive engagement, and the opportunity to respond to the policy options on the revised draft Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (**APS 117**), which were presented to industry on 18 May 2023.

The ABA acknowledges the challenges in constructing an IRRBB framework that is stable yet risk sensitive and minimises the risks of unintended consequences. To assist APRA in finalising its position regarding the revised APS 117, the ABA provides the following feedback.

Stressed Period – Fixed and Rolling Observation Periods

The ABA supports the proposed change to the stressed period, removing the Global Financial Crisis period by including a 3.5 year fixed observation period (spanning January 2020 to June 2023) and a rolling observation period (of 4.5 years). With this change, we believe APRA has moved in the right direction.

We do however remain concerned that this does not remove the potential for large movements in the IRRBB capital charge in the future driven by the time scaling approach which does not reflect the mean reverting nature of credit spreads. The ABA notes that there are a number of academic papers that explore this topic, and present alternative models.[1] The ABA would appreciate clear guidance from APRA on the expected policy response if a significant market shock impacted IRRBB capital requirements calibration, so ADIs can consider this policy response in their capital planning and stress testing processes.

Embedded Gains and Losses

It remains the ABA's view that the IRRBB framework should be symmetric throughout the economic cycle and remain representative of exposures across the system with both embedded gains and losses (**EGL**) recognised in the framework. The theoretical reasoning for potentially excluding embedded gains is unclear to industry as these are real gains and should not be ignored. Ignoring can potentially create perverse accounting driven incentives to hold or dispose of the existing positions.

It remains the view of industry that there are more appropriate mechanisms, in the (broader) prudential framework, to adjust the total level of (IRRBB) capital, rather than apply one-sided treatment in the EGL calculation, should that be required.

It is industry's expectation that α scalar will be set to reflect higher actual capitalisation rather than the currently implied 8%. Additionally, industry would welcome further engagement with APRA regarding the operation of the α scalar in the proposed model, including to better understand how the scalar is expected to function throughout the economic cycle.

[1] For example Prigent, J.-L., Renault, O and Scaillet, O (2001) *An empirical investigation into the credit spread indices*, Journal of Risk, 3 (3). pp.27-56. ISSN 1465-1211

Earnings Offset

The ABA's strongly preferred option of the choices APRA presented at the meeting on 18 May is that there be no change to the current treatment of the one-year earnings offset. The earnings offset is the only consideration of earnings stability given by APS 117 capital calibration requirements and we would refer you to previous submissions for detailed feedback on this position.

Observation Period and Data Frequency Update

Most ABA members welcome the policy option to revert the data frequency update of the 8-year observation period to quarterly. This, in industry's view, should reduce the risk of a 'step change' in the metrics, which could have resulted in annual updates.

Noting the more frequent update period and the setting of a 'fixed observation period' in the prudential standard, the ABA is of the opinion that the requirement to "*immediately update the 8-year observation period*" is no longer relevant and recommends for it to be removed.

Other Observations

The ABA has previously provided comment on the overly conservative outcomes from using of a scaled 1 year holding period on Credit Spread Risk in the Banking Book. ABA remains of the view that this can result in capital outcomes not aligned with the underlying credit spread risk of the financial assets, and can introduce significant volatility of capital requirements in the event of a short term shock in credit spreads due to failure to reflect the mean reverting nature of this risk factor. This outcome could provide disincentives to hold certain securities, particularly long-dated semi-government securities. The ABA remains of the view that a shorter holding period is in some cases appropriate, and we would refer you to our previous submissions for detailed feedback on this position. We encourage APRA to engage with the RBA and State Borrowing Authorities to ensure all implications of this proposed approach are fully understood.

Additionally, industry would welcome consultation on revised reporting standards sooner rather than later (give the technical build required if going into APRA cube) and would also welcome consultation on the approach to reaccreditation over the next 18-months, particularly the 3 month parallel testing requirement and iterative model drop approach.

Next Steps

We look forward to continued engagement on this important topic. If you would like to discuss or require additional information on any matter raised in this letter, do not hesitate to contact at

Regards,

Policy Director
Australian Banking Association

About the ABA

The Australian Banking Association advocates for a strong, competitive and innovative banking industry that delivers excellent and equitable outcomes for customers. We promote and encourage policies that improve banking services for all Australians, through advocacy, research, policy expertise and thought leadership.