



3 March 2023

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General Manager, Policy
Australian Prudential Regulation Authority

By email: ██████████

Dear ██████████

Interest Rate Risk in the Banking Book

The Australian Banking Association (**ABA**) welcomes the opportunity to respond to the Australia Prudential Regulation Authority's (**APRA**) new proposed revisions to Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (**APS 117**).

The ABA welcomes the enhancements to the draft APS 117 to produce a more stable Interest Rate Risk in the Banking Book (**IRRBB**) capital charge; to strengthen governance and oversight; and to standardise the approach taken between banks. However, the ABA believes that modifications to the proposed approach could also enhance the framework's robustness to future interest rate changes and create better incentives for Authorised Deposit-taking Institutions (**ADIs**) in managing their IRRBB risk.

The ABA acknowledges the objective to reduce volatility in the IRRBB capital charge. We view that proposals to address this should be symmetric throughout the economic cycle and remain representative of exposures across the system. In that light, the ABA has offered some suggestions on how this could be balanced with their impact on incentives and banks' ability to manage risk.

Key concerns with the proposals include:

- The non-recognition of embedded gains undermines the use of an investment term of capital (**IToC**) as a key mitigant of capital ratio pressure in a crisis, exacerbating the volatility caused by the IRRBB capital charge on government and semi-government securities;
- The removal of the earnings offset increases the IRRBB capital required to support a prudent IToC strategy, incentivising ADIs to be more exposed to falling rate environments; and
- The inclusion of a stressed period in the historical simulation, without further calibration, may put a floor on IRRBB Risk Weighted Assets (**RWA**) at near all-time highs, resulting in significantly more capital being required.

The ABA recommendations aim to address these concerns and are aligned with the principles published by the Basel Committee on Banking Supervision (**BCBS**, 2015-2016). Adopting these standards would enhance the framework and create better incentives for ADIs in managing their risk.

This cover letter is supported by three **Annexures**, which set out our views in more detail:

- **Annexure 1** outlines the several key thematic concerns identified by the ABA and its members that lie across the proposals, and the position of BCBS on those topics;
- **Annexure 2** responds to several specific proposals contained in the revised APS 117, namely embedded gains and losses, the stressed period, and earnings offsets; and
- **Annexure 3** raises some additional areas that were not the subject of specific consultation but the ABA and its members believe warrant further attention.



Next Steps

As the proposed changes are impactful, complex and interlinked, the ABA encourages APRA to continue its engagement with industry to fully understand their implications and, where appropriate, explore alternatives. While this may present challenges to finalisation of revised APS 117 by mid-2023, the ABA believes it is important to continue close engagement. The full implications of the proposals remain unclear, as banks collect and analyse the data requested to respond to APRA's QIS.

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 the ABA at [REDACTED]

Regards,

[REDACTED]
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.



Annexure 1: Thematic Concerns

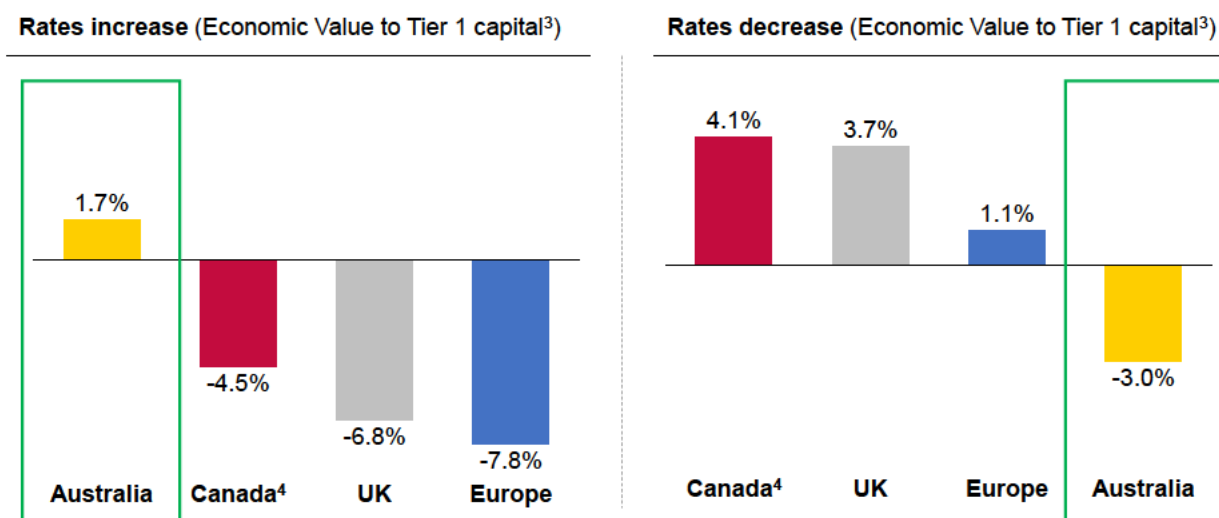
1.1 Limited consideration to system stability

The draft APS 117 considers a duration of equity of zero equivalent to ‘IRRBB risk free’¹, and refers to earnings volatility hedges as ‘*practices of earnings “smoothing”*’. In its current form, the revised draft APS 117 gives limited consideration to earnings volatility risk, using the risk of fall a in economic value of banking book items as the key driver of the calibration of capital requirements.

This perspective does not adequately balance the two main IRRBB risks, as per APS 117 definition², and flows into multiple elements of the standard. For example, by limiting the maximum term of deposits’ hedges to half of the limit established by BCBS, or by incentivising the reduction of the duration of equity towards zero through lower capital requirements.

Global benchmarks suggest that the Australian financial system is already more exposed to a falling interest rate environment, which typically corresponds with economic downturns, where banks’ capital is already under stress. Figure 1 shows the sensitivity of banks’ economic value to interest rate shocks, applying BCBS methodology consistently across jurisdictions³.

Figure 1:⁴ Sensitivity to an interest rate shock as per BCBS methodology¹ (FY22/ 1H22²)



1. Australian banks modelled based on their structural positions, assuming: equity hedge of \$202 billion invested over a 3-year term, non-maturity deposits hedge of \$310 billion with an average maturity of 4.1 years (European and UK banks average) invested over a 5-year term.
2. Includes a sample of the largest 15 European banks, 5 Canadian banks, 5 UK banks and 4 Australian banks, by Tier 1 capital. Reporting between June 2022 to October 2022 for 28 banks, and December 2021 for 1 bank (DZ Bank).
3. Chart represents the median of Canadian, UK and European banks
4. Shock to Canadian banks scaled from 100 basis points to 200 basis points, consistently with Basel Committee.

Despite this higher exposure to falling rates, the four major Australian banks hold \$164 billion of IRRBB RWA largely driven by the hedges to mitigate this exposure. Under the proposed APS 117, Australian banks could reduce IRRBB capital requirements by further increasing their vulnerability to falling rates, by incentivising banks to reduce their duration of equity towards zero.

¹ “ADIs can mitigate IRRBB risk by [...] minimising their level of fixed interest rate risk; and shortening the duration profile” (Figure 1, Response to submissions, November 2022.)

² “Risk of loss of in earnings or fall in the value of banking book items” (Executive summary, Response to submissions, November 2022)

³ The main difference versus Australia’s external reporting is the capitalisation of the net position between deposits (~4.1 years of average maturity, based on European and UK average) and deposits’ hedges (2.5 years of average maturity).

⁴ This data has been created by an ABA member to illustrate the points made in this submission. The ABA and relevant member would be happy to explain the methodology and underlying assumptions to APRA.



BCBS has noted the risks of a prudential framework, such as APS 117:

...a Pillar 1 capital framework for IRRBB which creates incentives to exclusively minimise reductions in Economic Value of Equity may lead to unintended consequences” and “might generate adverse incentives for banks to change the repricing profiles of their banking book in order to drive the duration of assets (and hence minimum capital requirements) towards zero”. On the other hand, the BCBS acknowledges that “there is a trade-off between optimal duration of equity and earnings stability that supervisors may wish to preserve in a capital framework.⁵

Prudential authorities across western economies, such as the United States (**US**), the United Kingdom (**UK**), Europe and Canada, have adopted BCBS recommendations and give strong consideration to earnings stability in their prudential framework. For example, as opposed to Australia:

- none apply stricter limits to the maximum term of deposits’ hedges than BCBS;
- none apply automatically higher capital requirements to longer durations of equity;
- the European Banking Authority has proposed a threshold to identify banks with excessive earnings volatility⁶; and
- US banks focus their IRRBB external reporting exclusively on earnings stability.

1.2 Approach to credit spread risk

APS 117 requires banks to hold capital for credit spread risk arising from any security held in the banking book, regardless of the business intention or accounting treatment. As a result, a security that is held with a business objective of collecting contractual cash flows attracts a disproportionate amount of capital requirements compared to a loan that has exactly the same business objective and accounting treatment.

This approach is not aligned with the underlying credit spread risk of the financial assets: compared to loans, securities are typically issued by higher-rated parties, with lower credit spread and liquidity risk. In contrast to the current revised draft APS 117, BCBS proposes consistency across financial instruments by limiting the scope of credit spread risk in the banking book to items designated as fair value, whose business model’s objective includes trading the asset.

Moreover, in light of recent markets volatility, prudential regulators and banks globally have adjusted their policies and business practices to protect banks’ capital ratios from the deterioration of the value of government securities. In June 2020, the European Parliament approved a policy modification to remove the impact of unrealised losses from government securities designated as fair value from banks’ regulatory capital. In 2022, US banks largely shifted from designating government securities at fair value to amortised cost, in order to protect their capital base.

Australian banks do not have the flexibility of shifting the business practices to protect their capital ratios. As noted in the ABA letter “*APS 117 IRRBB Policy Proposals*” (April 2022), the current approach to spread risk represents a very significant risk to the stability of the Australian financial system. The proposed asymmetrical treatment of Embedded Gain and Losses (**EGL**), where only embedded losses are considered for capital purposes, removes a significant offset that exists in the current APS 117.

As an illustrative example, under the proposed revised APS 117, the capital required for a AAA-rated 10-year NSW or Victoria state government security is higher than that required for a 10-year triple-B corporate unsecured loan and close to four times higher than for a 30-year home loan (Figure 2).

Increases in IRRBB capital requirement for state government securities, may challenge the ability of banks to hold these assets in their HQLA portfolio, which may have broader system implications (outside of prudential considerations) such as reduced capacity of state governments to fund deficits. Given these

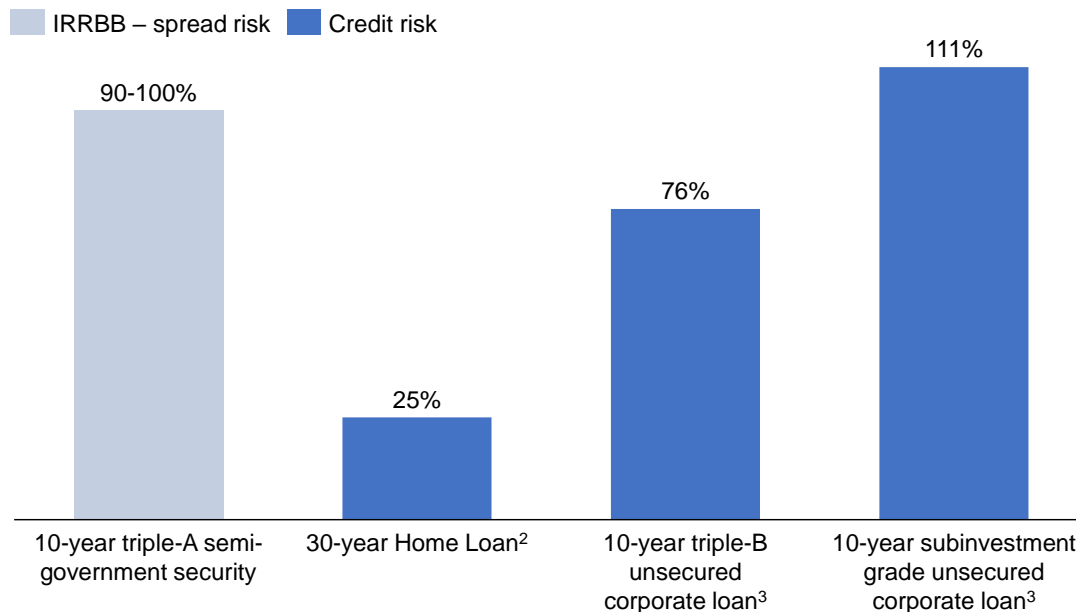
⁵ BCBS Consultative Document, Interest rate risk in the banking book (June 2015)

⁶ EBA/RTS/2022/10 (October 2022)



broader implications, we encourage engagement with the RBA and State Borrowing Authorities to ensure all implications are fully understood.

Figure 2:⁷ Credit and IRRBB RWA to exposure by financial instrument (%)



1. ~0.1% loss in economic value per basis point of higher spreads in a 10-year semi-government security; equivalent to a RW of 90-100% calibrated based on GFC (i.e., 0.1% loss x 75 bps annualised shock x 12.5 prudential scalar).
2. Average Home Loan risk-weight for the four majors.
3. Large Corporate unsecured loan with a maturity >5 years and S&P rating of BBB (PD=0.17%) and BBB (PD=0.40%).

1.3 Disproportionate capital requirement

Capital requirements under APS 117, mostly driven by duration of equity, are disproportionate to the underlying risk. For Australia’s major banks, as of 1 January 2023, it is estimated to be higher than the capital required for exposures to domestic commercial real estate.

The ABA is not able to design any plausible scenario where banks would lose a material proportion of their IRRBB capital requirement. September 2022 levels of capital would be sufficient to withstand an implausible scenario where the 30-year record-high levels of embedded losses increase five-fold⁸ and banks lose all of their equity, with both events occurring simultaneously in less than twelve months.

In the ABA’s view, the substantial IRRBB capital requirement is due to the assumption that the equity hedge is unfunded, assuming that banks have no capital or operate on a ‘gone-concern’ basis.

IRRBB is the only form of RWA calibrated on a ‘gone-concern’ basis, while inconsistently requiring Tier 1 or ‘going-concern’ capital to absorb unexpected losses. This inconsistency is unique to the Australian prudential framework, and the result of a calibration of capital requirements driven by economic value measures (see section 1.1). BCBS has stated that “*an earnings-based measure is better suited to measuring the short- and medium-term vulnerabilities of the bank to IRRBB, assuming that it is able to continue in business (a going-concern viewpoint)*”.

⁷ This data has been created by an ABA member to illustrate the points made in this submission. The ABA and relevant member would be happy to explain the methodology and underlying assumptions to APRA.

⁸ As of September 2022, the four major banks reported \$5.9 billion of expected losses (\$74 billion RWA/ 12.5) and ~\$30 billion of total IRRBB capital requirements (\$164 billion RWA x >17.5% target capital ratio, including additional Tier 1 and Tier 2 requirements).



1.4 Complexity and timelines of implementation

As noted above, the proposed revisions to APS 117 are impactful, complex and interlinked. Banks' ability to implement the changes is contingent on the release of the final APS 117 and related APG 117. The ABA recommends that sufficient time for engagement and consideration be permitted, rather than meeting a defined implementation deadline.

Once the finalised APS 117 and APG 117 are released, banks will need a minimum of 18 months to embed and implement the changes, particularly if APRA require banks' final models to be submitted 6 months before the 'go-live' date. The ABA requests that APRA take this lead-time into consideration as the revised APS 117 and APG 117 progress.

The ABA appreciates that APRA has sought solutions to several issues arising from industry submissions, and recent experience. However, the ABA notes that, in some cases, this significantly increases complexity, both in terms of model build and ongoing maintenance. It might also have other potential unintended consequences, such as the deduction of embedded losses from Common Equity Tier 1 (**CET1**).

Industry would therefore be supportive of a simpler framework overall and are available to continue to work with APRA to identify additional opportunities for simplification.



Annexure 2: Observations on Specific New Proposed Revisions

2.1 Stressed period

“APRA is proposing to demarcate the 8-year observation period into the concatenation of a 1- year stressed period and a 7-year latest data period. The choice of stressed period is the period that would give rise to the highest prospective IRRBB capital charge based on an ADI’s current banking book portfolio composition.”

“APRA considers a 1-year stressed period as theoretically sound, given that most interest rate stresses are typically contained within a 1-year time horizon, and expects that most of the stressed period will dominate the 97.5 per cent expected shortfall tail and IRRBB capital outcome.”

[Response to Submissions Nov 22, 3.3 Stressed Period]

The proposed APS 117 revisions to introduce a stressed period to generate the highest prospective IRRBB capital charge may reduce volatility. It is based on breaking the 8-year observation period from the prior draft into the concatenation of a 1-year stress period and the latest 7-year data period. We acknowledge APRA’s objective to reduce IRRBB capital volatility, but will do so at the cost of increasing the already disproportionate IRRBB capital requirement for a given risk position in perpetuity (as additional stress periods are created). That is, it will result in a significant increase in the level of IRRBB capital that banks are required to hold.

Industry anticipates a significant increase in yield curve and repricing risk from the introduction of this stressed period and the proposed shock scaling. The over estimation of shocks is of particular concern with relation to spreads seen during the stressed window (possibly GFC) given the size of this stressed event being scaled.

The requirement for a 1-year holding period has not changed between the current standard and the proposed draft. However, the ABA believes that its appropriateness should be reviewed, considering:

- As noted by BCBS, banks have the ability to adjust their IRRBB profile in a period much shorter than one year. BCBS proposes *“a six-month holding period for the interest rate shock calibration to be suitable for IRRBB capital purposes. Most institutions appear to have the ability to adjust their asset/liability profile in a period much shorter than one year”*.
- Historically, the 1-year holding period was set to reflect the difficulty in ‘resolving’ an illiquid banking book portfolio. However, the introduction of a ‘market-related’ portfolio identifies a key subset of the banking book, which is readily tradeable and comprises highly liquid securities (for the high-quality liquid asset portfolios designated at fair value in particular).
- Interest rates and credit spreads do in fact display mean reversion. Therefore, such a short shock relative to the holding period may lead to overestimating the shocks used in the capital calculation. This is particularly clear in the case of credit-spread risk, for which the ‘square root of time’ approach can be empirically shown to misrepresent actual behaviour. Specifically, industry observes that credit-spread shocks are short and severe, with significant reversion. Consequently, the application of a multiplier to those short-term moves results in shocks far in excess of what has been observed historically for the relevant asset classes.

Recommendation: The ABA recommends consideration of the following options:

- The adoption of a 6 months holding period, and consider a shorter holding period (e.g. 1-3 months) for the market-related portfolio or, in the alternative, other mechanisms for calibration – such as standardised stocks.
- The 2020-2023 period already has significant credit spread stress periods, rates up and rates down scenarios, and will remain part of the 8-year history set for quite some time. Noting that pure historical simulation may miss certain risk types, APRA may wish to consider reserving the right to mandate an



ADI or the entire industry to use a certain time period or fixed stresses if a future history set shows inadequacies. This could allow flexibility without locking in the requirement to use a stressed period in perpetuity.

- In recognition that the stressed period is, by definition, extreme in nature, APRA may wish to consider a shorter holding period scaling factor (eg. 3-6mths) for these scenarios so as not to excessively scale up short-term shocks and help to calibrate the overall IRRBB capital requirement.
- Given the 2008-9 GFC period is likely to be a significant factor for spread risk on liquid assets, APRA may wish to consider applying a shorter holding period scaling factor (3-6mths) to liquid assets and their associated hedges. We note that this raises the question of how to clearly distinguish between liquid asset hedges and hedges of Non-Market Related balance sheet activity.

BCBS position: BCBS recommends a 6-month holding period, acknowledging this to be a conservative assumption (June 2015 Consultation 2.2).

2.2 Embedded Gains and Losses

“Under the current APS 117, embedded gains and loss (EGL) is an input in the IRRBB RWA calculation. APRA is proposing to remove EGL from APS 117, with embedded loss to be treated as a regulatory adjustment i.e. a CET1 capital deduction under APS 111.”

“This proposal is intended to create better incentives in the IRRBB RWA framework to better shape the behaviour of ADI’s balance sheet management and practices to a change in interest rate environment.”

[Response to Submissions Nov 22, 3.1 Embedded gains and loss]

The ABA welcomes the intent to reduce volatility from moving EGL from RWA to a capital deduction. However, the proposed approach brings additional complexity, and may impact other parts of the prudential framework such as:

- Implications in other APS 111 components, such as the calculation of capital requirements for subsidiaries on a Level 1 basis, or APS 222 limits (noting that this raises the risk that it will create greater volatility in the overall CET1 ratio); and
- Implications for introduction of the standardised floor under capital reforms, which should give consideration to the EGL impact in capital given that it is a component that applies exclusively to advanced ADIs. We note that industry’s understanding of APRA’s intention with Capital Reforms was that the floor would not be the binding constraint, whereas it may be more likely to be the constraint if a deduction approach is adopted.

More broadly, a longer term IToC has been an important support mechanism against capital weakness through past crises. In recent stress test scenarios, the RWA benefit from embedded gains and losses has been an important mitigant helping maintain the desired level of capital. We further note that the Basel Framework includes this as a Pillar 2 requirement only.

The ABA believes that the impact of EGL should be symmetrical rather than capping embedded gains to zero, considering:

- Capping embedded gains to zero further increases the significant volatility of the IRRBB framework under a credit spread shock, where rates tend to fall, and embedded gains offset the increase in RWA calibration. March 2020 is a clear example of this situation.
- The revaluation of banking book items designated at fair value through other comprehensive income is captured through reserves, which are not capped at zero. This could create an undue difference in capital requirements across ADIs depending on their accounting practices.



Finally, for the reasons outlined in section 1.3, the ABA believe that EGL would be more appropriate as Tier 2 capital deduction ('gone-concern' basis).

Recommendation: The ABA recommends:

- The revised framework maintain a symmetrical treatment of EGL, considering both gains and losses;
- Reduce volatility in the calculation for EGL capital within APS 117 by amending the multiplier to reflect high capital ratios and the Capital Reform requirements, that is the 12.5 scalar is calibrated to a CET1 ratio of 8.0%. Following APRA's Capital Reforms, the new top of the CCB is 10.25% and therefore a recalibrated scalar to be 10.25; and
- Ensure that it does not interfere with other components of the framework (e.g. capital requirements for subsidiaries, output floor, APS 222 limits).
- The industry's previously expressed preference is for EGL to be treated as a Tier 2 deduction/addition;

BCBS position: The ABA questions the interpretation that "the Basel Committee's approach [...] only recognises embedded loss". None of the four options proposed by BCBS for a potential IRRBB Pillar 1 capital requirement (2015) considered neither embedded gains nor embedded losses. As such, completely removing EGL would be the closest methodology to BCBS view of potential Pillar 1 approaches. While the final BCBS standards (2016) note that capital adequacy assessment for IRRBB should factor the impact of embedded losses, the ABA believes that the risk of potential future embedded losses is already captured in APS 117 through repricing and yield curve risk, calibrated based on the shock that originated the current level of embedded losses.

2.3 Earnings offset

"Under the current APS 117, an earnings offset is calculated as part of estimating the impact of changes to the economic value of the banking book. The earnings offset is an adjustment for the impact of interest rate changes on economic-value based earnings over a one-year holding period."

"APRA has observed that the current setting of a one-year earnings offset does not bear any material outcome on ADIs' choice of banking book profile or balance sheet management strategy. Rather, earnings offset provides a benefit to IRRBB capital requirements. As such, APRA views the earnings offset as a calibration component within the IRRBB capital calculation."

[Response to Submissions Nov 22, 3.2 Earnings Offset]

In general, APS117 gives limited consideration to earnings volatility risk and instead focuses on the risk of a fall in the value of banking book items as the key driver of the calibration of capital requirements. The primary benefit of an IToC to be the support it provides the banking system in periods of stress and crisis with large falls in prevailing interest rates. Maintaining an appropriate incentive framework for banks to prudently manage IRRBB via an IToC allows for this benefit to be realised. The earnings offset is the only consideration to earnings stability currently given by APS 117 capital requirements calibration. Removing it would further increase the incentive for ADIs to reduce their investment term of equity to zero.

This is not a risk-free approach, as it would result in ADIs taking on a material level of earnings risk on a going-concern basis. This would increase the risk to the system in the event of severe downturns associated with a falling rate environment by removing key counter-cyclical earnings buffers.

Regarding APRA's observation that there is no theoretical justification for a 3-year investment term, the ABA notes that stress testing can support that equity hedges invested over a 3 to 5-year term would remain funded with a very high degree of certainty. In addition, there is also limited theoretical justification for considering zero or 1-year investment term as risk-free.

Recommendation: The following recommendations are ranked in order of the preference of the ABA and its members:



- Continue to provide an earnings offset provision, decoupling it from the 1-year holding period and incentivising prudent management of risk through a longer tenor. This tenor and/or percentage of CET1 it applies to could be agreed individually with ADIs as part of internal model approval or mandated across the industry. This approach would be consistent with the treatment of non-maturity deposits, which are similar in risk profile.
- Extend the earnings offset to a 3 to 5-year investment term, strengthening the consideration given by APS 117 to earnings volatility risk.
- Maintain a 1-year investment term.

BCBS position: The inclusion of the investment term of equity as part of ADIs' internal model approval would:

- align with BCBS "earnings-adjusted Economic Value measure" to preserve an adequate balance between economic value and earnings stability
- mitigate the unintended consequences of a Pillar 1 framework exclusively focused on Economic Value;⁹ and,
- improve the consistency of the calibration of the framework

2.4 IRRBB observation period and data frequency update

"APRA considers having a 1-year stressed period within the 8-year observation period lends support to reducing the data frequency update from quarterly to annually. As such, APRA is proposing that the 8-year observation period be updated annually."

[Response to Submissions Nov 22, 3.4 IRRBB observation period and data frequency]

The revised draft standard requires that banks use the last 7 years of data updated annually, as opposed to the current standard requiring the use of the last 6 years of data updated at least quarterly. Industry understands the proposed change aims to address the objective of the prudential standard reform to provide consistency in capital charge calculation. The annual update could provide a step change in the metrics that may not be consistent with the current conditions and portfolio changes over the period.

Some ABA members believe that the impact of requiring annual update could lead to the window update being not timely and not reflective of the changed market conditions.

Whilst the approach for updating the window on a more frequent basis may not be consistent among the banks and this can lead to difference in the requirements for capital, it provides ability to reflect current market conditions in a more timely manner.

In addition, annual update does not necessarily achieve consistency as it may occur at different times across banks. Lastly,

Recommendation: The ABA recommends to modify

the draft standard from "updated annually" to "updated at least annually" to provide increased flexibility and the ability to reflect market conditions in the capital calculations on a more contemporaneous basis.

2.5 Banking book profile

The ABA broadly agree with the recommendation that capital hedging programs are subject to clear governance and Board approvals.
Annexure 3: Additional Areas

⁹ Consultative Document – Interest rate risk in the banking book (September 2015), Executive summary and section 4.2.



3.1 Core deposits

The proposed revisions to APS 117 include, as optionality risk, the possibility that non-rate sensitive deposit balances fall, leaving banks with unfunded hedges that could result in losses if rates rise.

The ABA believes that the scaling of 0.9 applied for this optionality risk is duplicative with the 90% cap applied to the maximum proportion of core deposits. As noted above, it further incentivises banks to reduce interest rate hedges, taking on more earnings risk and further exposing them to falling rate environment.

Recommendation: The ABA recommends the removal of the optionality 0.9 scalar applied to non-rate sensitive deposits.

BCBS position: BCBS imposes less restrictive constraints to the hedging of non-rate sensitive deposits by imposing a cap on average duration of core deposits of 4-5 years, compared to the 2.5 years cap included in the draft APS 117.

3.2 Scope of credit spread risk

APS 117 requires banks to hold capital for credit spread risk arising from any security held in the banking book, regardless of the business intention or accounting treatment. This creates an inconsistency in the assessment of credit spread risk for financial instruments with similar business models.

Recommendation: The ABA recommends that APRA change the scope of market-related items from “*all securities in the banking book*” to “*all securities designated at fair value in the banking book*”. This proposal is consistent with APRA’s considerations noted in section 2.9 of the APS 117 consultation paper (November 2022): it covers for the mark-to-market risk of the exit price of the bonds designated at fair value; and would require ADIs to make strategic decisions on their composition of HQLA (e.g. modifying the business model and accounting designation, in addition to the mix of securities).

BCBS position: This proposal is aligned with BCBS standards.¹⁰

3.3 Valuation of non-market-related item

The ABA notes the requirement to ensure discounted cash flows of non-market related items are equal to the purchase value at inception. The ABA is concerned there are several requirements in the draft, which may not be consistent with internal Funds Transfer Pricing (FTP) policy, and therefore make this requirement difficult to meet.

The value of a non-market related items at inception is based on the interest cash flows from the projected FTP rate assigned by the bank and discounted using the corresponding curve. For this requirement to stand true, the FTP rate would need to match the non-market related rate exactly.

There are several instances where it may be difficult to achieve this, in particular where the rates are different (e.g. time snaps of the FTP and valuation curves or repricing profile used to assign the FTP rate may not match the repricing profile used to model the non-market related item in the IRRBB model). The draft APS 117 set prescribed requirements for how banks are required to model the repricing profile within the model (e.g. use behavioural if historical data supports). This may differ from how banks define the repricing profile for FTP, e.g. using contractual flows.

In addition, there may be several examples where multiple curves are used to assign FTP rates. This only occurs where there is rational business logic, and it is part of an ADI’s internal transfer pricing process. The draft APS 117 states that “an ADI may, with APRA’s approval, use more than one NMR curve per currency to which an ADI has non-material exposures in exceptional circumstances”.

¹⁰ Standards – Interest rate risk in the banking book (April 2016) – Annex 1, Figure 1.



Recommendation: The ABA recommends modifying the language of the standard regarding the valuation of non-market related items:

- Allow central repricing assumptions to match internal repricing and remove paragraph 27, Attachment B. Alternatively, modify paragraph 27 to require similar methodology and curves be used to derive total value but not necessarily zero value at inception; and
- Remove the word “exceptional” from paragraph 13, Attachment B.

3.4 Other technical clarifications

The ABA would appreciate further technical clarifications on the drafting of APS 117:

- Paragraph 15, Attachment B: Further clarity is required on the meaning of “*ending on a date no earlier than 3 months before the calculation date*” versus “*updated annually*” (emphasis added).
- APS 117 consultation paper (November 2022): the paper indicates that “*if an ADI materially changes their banking book profile (including their choice of the maturity of shareholders’ equity), then the ADI must immediately update the 8-year observation period.*” Further clarification on what constitutes “material changes” requiring an immediate review of the eight-year horizon would assist industry better understand APRA’s intent. The current wording could lead to situations where ADIs are required to run an expected shortfall calculations on an increasing number of scenarios to ensure they are identifying the stress period with the “highest prospective IRRBB capital charge”.
- Paragraph 2, Attachment B: unclear that “d” and “d3” are the same date.
- Paragraph 10 (b), Attachment B: “Pays” makes it unclear on the status of non-interest bearing (NIB) products for core deposits.
- Paragraph 20, Attachment B: “min” should read “max”
- Paragraph 20, Attachment B: Comparing the EV of the portfolio at the calculation date versus the EV of the portfolio with repricing assumptions together with simulated risk factors, is creating a feedback loop between the replicating portfolio’s currently EGL and the final OCCd (optionality capital at the calculation date). Any embedded gain in the replicated deposits will increase the optionality charge while any embedded loss will reduce the optionality