September 11, 2015

<u>Filed electronically</u>
William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland

Re: Consultative Document: *Interest rate risk in the banking book* (June 2015)

Dear Mr. Coen:

World Council of Credit Unions (World Council) appreciates the opportunity to comment on the Basel Committee's *Interest rate risk in the banking book* consultative document.[1] Credit unions are cooperative depository institutions that operate to promote thrift and financial inclusion, and World Council is the leading trade association and development organization for the international credit union movement. Worldwide, there are 57,000 credit unions in 105 countries with USD 1.8 trillion in total assets serving 217 million natural person members.[2]

We recognize the need for the Committee to revise its approach to interest rate risk regulation given the extraordinarily low-interest rate environment created by central banks in many jurisdictions since the financial crisis began in 2007. We urge the Committee to work with key central banks to ensure that policymakers raise interest rates in a controlled and predictable manner in order to mitigate interest rate shocks on financial institutions, and to limit changes in international capital flows which could disrupt local economies and create unintended credit risk problems.

World Council's detailed comments in response to the Committee's consultative document are below.

<u>1. World Council Strongly Supports Giving Supervisors Discretion Regarding Whether or Not to Apply this Standard to Non-Internationally Active Institutions</u>

World Council strongly supports the consultative document's statement that the proposed framework would be mandatory for large internationally active banks but that "[s]upervisors would have the national discretion to apply the [Interest Rate Risk in the Banking Book] framework to . . . non-internationally active institutions" or not. Credit unions rarely, if ever, operate on a cross-border basis and many of the calculations required by this standard may provide unreasonably burdensome and of relatively little supervisory value for small credit unions and other credit unions with less complex assets and liabilities.

[1] Basel Committee on Banking Supervision, *Guidance on accounting for expected credit losses -- consultative document* (2015), *available at* http://www.bis.org/bcbs/publ/d311.htm.
[2] World Council of Credit Unions, *2014 Statistical Report* (2015), *available at* http://www.woccu.org/publications/statreport.

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For example, the median asset size of credit unions in the United States is USD 25.5 million in total assets, with over 3,000 US credit unions having less than USD 25.5 million in total assets.[3] Financial institutions of this size would likely find it difficult and/or unreasonably time consuming to perform many of the calculations proposed by this consultative document. Small financial institutions are also unlikely to have significant interest rate risk on their balance sheets because substantial investments in long-term assets would likely constrain their liquidity positions.

Many larger credit unions have similarly non-complex assets and liabilities because credit unions' business activities are limited primarily to making loans to members, investing in bank deposits or central credit union deposits, investing in service bureaus and similar credit union service organizations, and investing in debt instruments guaranteed by national, provincial or local governments. Some jurisdictions also allow credit unions to invest in mortgage-back securities (which often have a governmental credit guarantee) and/or interest rate derivatives tied to a particular loan or loans made by the credit union (such as to turn a fixed-rate mortgage functionally into an adjustable rate mortgage during the duration of an interest rate swap).[4]

Based on data from the US Credit Union National Association, the 6,330 credit unions in the United States had approximately USD 1.2 trillion in total assets with USD 772.3 billion in total loans as of July 2015.[5] In terms of loan origination, roughly 28.1 percent of loans made by US credit unions at that time were long-term, first-lien mortgages with fixed rates that never adjust over the life of the loan (which typically have a tenor of 15 or 30 years),[6] but many credit unions sell their long-term fixed-rate mortgages into the secondary market instead of holding them in portfolio.

In terms of investments in securities, data from US credit unions' quarterly "5300 Call Reports"[7] filed with the US National Credit Union Administration (NCUA) indicate that US credit unions had approximately USD 51 billion in hold-to-maturity securities investments, nearly USD 172 billion in available-for-sale securities, and USD 709 million in securities held for trading at the end of March 2015.

Based on data from Credit Union Central of Canada (CUCC), the 303 credit unions in Canadian provinces other than Quebec had roughly CAN 177 billion in total assets and nearly CAN 150 billion in loans as of the end of June 2015.[8] In terms of mortgages, these credit unions hold approximately CAN 182 billion in residential mortgages, approximately CAN 29 billion in commercial mortgages, and about CAN 2.8 billion in agricultural mortgages. Roughly 70 percent of the residential mortgages have interest rates that typically adjust every five years or less, and the

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[3] Credit Union National Association (CUNA), *U.S. Credit Union Profile: First Quarter 2015* (2015), *available at* http://www.cuna.org/Research-And-Strategy/Credit-Union-Data-And-Statistics/
[4] *See, e.g.*, 12 C.F.R. § 701.21 ("Loans and Lines of Credit to Members."), *available at* https://www.law.cornell.edu/cfr/text/12/701.21; 12 C.F.R. § 703.14 ("Permissible Investments."), *available at* https://www.law.cornell.edu/cfr/text/12/703.14.
[5] CUNA, *Monthly Credit Union Estimates* (July 2015), *available at* http://www.cuna.org/Research-And-Strategy/Credit-Union-Data-And-Statistics/
[6] *Id.*
[7] NCUA, 5300 Call Report Quarterly Data; http://www.ncua.gov/dataapps/qcallrptdata/Pages/default.aspx.
[8] CUCC, *2Q 2015 System Results* (Aug. 26, 2015), *available at* http://www.cucentral.ca/SitePages/Publications/FactsAndFigures.aspx.

remaining 30 percent of Canadian credit unions' residential mortgage holdings have a floating interest rate that adjust more often than once a year.

CUCC data also indicates that these credit unions' aggregate holdings of investments in liquid securities (i.e. liquid investments other than cash and funds held by central credit union liquidity pools) total approximately CAN 3.7 billion.

We strongly support giving national and provincial supervisors discretion regarding whether or not to apply this standard to small or less-complex financial institutions like most credit unions. We believe that this approach is justified based on the actual composition of credit unions' assets and liabilities in the world's two largest and most complex credit union systems.

We urge the Committee to finalize as proposed the consultative document's statement regarding giving national supervisors discretion to apply this standard (or not) to non-internationally active institutions including credit unions.

2. World Council Supports Retaining a Standalone, Principles-Based Pillar 2 Approach to Controlling Interest Rate Risk that Allows Significant Supervisory Discretion

We believe that the Committee should retain a principles-based approach to interest rate risk under Pillar 2 and support the Committee's proposed standalone Pillar 2 framework. World Council also strongly supports the principle of proportionality expressed in Section III(2.3) of the proposed Pillar 2 framework.

We support the Committee's proposed stand-alone, enhanced Pillar 2 approach because it would allow supervisors sufficient discretion to prevent unintended consequences and unjustified regulatory burdens on credit unions that would be likely to result from a one-size-fits-all approach to interest rate risk regulation that is designed primarily for large internationally active banks.

3. World Council Does Not Support the Proposed Pillar 1 Approach

World Council does not support the Committee's proposed Pillar 1 framework either as a standalone framework or as a hybrid Pillar 1 and Pillar 2 framework. We believe that the consultative document's proposed Pillar 1 approach is overly prescriptive and inflexible. The Pillar 1 approach would also be more likely to impose unjustified regulatory burdens on community financial institutions like credit unions because it is less easily adaptable to different local economic conditions and different financial institution models. As noted above, World Council supports a standalone Pillar 2 framework.

If, however, the Committee selects the proposed Pillar 1 approach, World Council would support the "option 3" set forth in section II(5.4) of the consultative document where short-term gains may offset losses associated with changes in the economic value of equity of a financial asset. We urge the Committee, however, to allow significant supervisory discretion if it adopts the Pillar 1 framework in either a standalone framework or as part of a hybrid Pillar 1 and Pillar 2 framework.

World Council therefore does <u>not</u> support the proposed restriction in section II(2.2) on national discretion which reads: "The shocks should not be left to the discretion of national supervisors and should ideally reflect each country's local economic environment, including in particular the level and the volatility of the interest rate." We urge the Committee <u>not</u> to finalize this aspect of the proposal.

We are not sure, as a practical matter, how interest rate shocks that "ideally reflect each country's local economic environment . . ." can be set without the involvement of the local government, especially considering that national and provincial supervisors are the agencies that have the greatest access to financial institutions' non-public information concerning their assets and liabilities and often can only share it on a limited basis.

There are also significant differences between the interest rate environments and stability of banking systems from jurisdiction-to-jurisdiction even when the national economies involved are closely linked. We urge the Committee to give national and provincial regulatory authorities sufficient discretion to design interest rate shocks that take into account local economic conditions.

We support the six interest rate shock scenarios proposed in section II(2.2) to the extent that the Committee adopts a Pillar 1 approach. The interest rate shock scenarios appear reasonable from a theoretical perspective, although we believe that the Committee should study these models further to assess how realistic these scenarios truly are because the Economic Research Department of the Federal Reserve Bank of San Francisco has recently issued a report concluding that the Committee's interest rate shock scenarios "are very unlikely to occur."[9]

We also urge the Committee to consider whether these calculations could be integrated with other Pillar 1 risk components such as credit risk, rather than setting the capital requirement for various risks independently. For example, rising interest rates typically lead to an increase in defaults on loans with adjustable rate features that is more tied to credit risk than to interest rate risk per se. This integrated approach could either be as part of this standard, or as part of a Basel IV standard if and when a Basel IV standard is proposed.

<u>4. Disclosure Requirements Should Not Disadvantage Less-Complex Financial Institutions</u>

Regarding disclosure requirements, we urge the Committee to ensure that these disclosure requirements do not disadvantage financial institutions like credit unions that do not have a holding company or an investment banking arm to which interest rate risk can be transferred.

We therefore strongly support the Committee's proposed requirement to include both on- and off-balance sheet items in a bank's interest rate risk calculations. We also believe that this analysis should be performed at the bank holding company level as well as at the depository institution level of a banking group.

[9] Jens H.E. Christensen & Jose A. Lopez, Federal Reserve Bank of San Francisco, *FRBSF Economic Letter* 2015-29 (Sep. 8, 2015), *available at* http://www.frbsf.org/economic-research/publications/economic-letter/2015/september/assessing-basel-bank-supervision-scenarios-for-interest-rate-risk/.

5. Definition of the "Banking Book"

We urge the Committee to clarify the definition of the "banking book" because the definition included in the proposal's introduction is circular by defining the "banking book" as composed of "banking book positions," i.e.: "Interest rate risk in the banking book (IRRBB) more specifically refers to the current or prospective risk to the bank's capital and earnings arising from adverse movements in interest rates that affect the institution's banking book positions."

We recognize that the Committee wishes this standard to apply to any type of interest-rate-based exposure. Some people, however, associate the term "banking book" with hold-to-maturity securities positions, and do not associate the term "banking book" with loans held in portfolio even though this proposal would apply to such loans.

For example, *InvestorWords* defines the term "banking book" as follows: "An accounting book that includes all securities that are not actively traded by the institution, that are meant to be held until they mature. These securities are accounted for in a different way than those in the trading book, which are traded on the market and valued by the performance of the market."[10]

Conclusion

World Council appreciates the opportunity to comment on the Committee's consultative document on *Interest rate risk in the banking book*. If you have questions about our comments, please feel free to contact me at medwards@woccu.org or +1-202-508-6755.

Sincerely,

Michael S. Edwards
VP and General Counsel
World Council of Credit Unions, Inc.

[10] http://www.investorwords.com/6739/banking_book.html#ixzz3lNTtqX2Z