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IRRBB

EBA publishes final guidelines on interest rate risk in the banking book

Regulatory Focus on IRRBB

The Basel Committee on Banking Supervision (BCBS) has included initial principles on the management of interest rate risk in the banking book (IRRBB) as part of the supervisory review (pillar II) as early as 2014. And it was after the replacement of corresponding 2006 CEBS guidelines by the publishing of the EBA guidelines (EBA/GL/2015/08) in May 2015, that the April 2016 release of BCBS 368 constituted the final Basel guidelines on this topic. An environment of recovering prime rates has led regulators to put more emphasis on interest rate risk in general and triggered the EBA release of an update to the corresponding EBA guidelines (EBA/GL/2018/02) on 19 July 2018 which is scheduled to enter into force as of 30 June 2019 and takes the standards formulated in BCBS 368 into account. The implementation of the final standards comes in two phases, where the recently published guidelines constitute phase I and the second phase is considered part of the still ongoing CRR / CRD IV overhaul. The greater part of the 2015 guidelines has been transferred into the new publication, which has been altered regarding its structure. Whereas the old guidelines had been separated into the two broader groups *High-level Guidelines* and *Detailed Guidelines*, the 2018 EBA guidelines are presented along six sections:

1. Subject matter, scope and definitions
2. General provisions
3. Internal capital
4. Governance
5. Measurement
6. Supervisory outlier test (SOT)

Subject Matter, Scope and Definitions

This section is dedicated to definitions and introduces *Gap Risk* and *Credit Spread Risk in the Banking Book* (CSRBB) to the list of relevant definitions. Both topics have already been addressed in the final standards of the Basel Committee and have now been included in the EBA's IRRBB publication to facilitate institutions' implementation planning. Nonetheless, finalisation of the corresponding guidelines is expected to be part of the CRR II / CRD V package. Smaller institutions of categories SREP-3 and SREP-4 (G-SIIs, O-SIIs and larger institutions fall under categories 1 and 2) need to take into account CSRBB by 31 December 2019.

General Provisions

The general provisions emphasise the influence of IRRBB on economic and earnings-based measures and advocate a sound risk management framework for IRRBB. When calculating IRRBB, institutions need not only consider interest rate derivatives but also non-performing exposures as interest rate sensitive instruments. In this light, non-performing refers to exposures that are material w.r.t. the competent authority's thresholds and that are at least 90 days overdue and/or where the counterparty is considered defaulted – regardless of the exposure being an outstanding or not. The exposures are to be considered gross of any posted collateral.

Internal Capital

The principles for internal allocation of capital have become more substantiated based on recent regulatory changes in accounting and now include a balance sheet view on IRRBB. Appropriate capital allocation for IRRBB in the future needs to consider interest rate risk from portfolios evaluated at fair value through other comprehensive income (FVOCI). The internal capital allocation also needs to reflect effects from interest rate sensitive instruments (e.g. interest rate derivatives) on the accounting P&L Statement and Equity. All of the various stress scenarios for interest rate risk need to be covered by sufficient capital in order to avoid adverse effects such as losses or dividend reductions in case of financial stress.

Governance

Considering the existing standards set by the Basel committee and the 2015 EBA Guidelines there are minimal changes introduced to the governance section of the new Guidelines. New products and/or business lines are required to undergo scrutiny w.r.t. their effects on interest rate risk already before they become business practice. The institutions must be able to provide evidence that the applied risk management tools can capture such risk but can delegate the corresponding risk management and steering to senior management or designated experts.

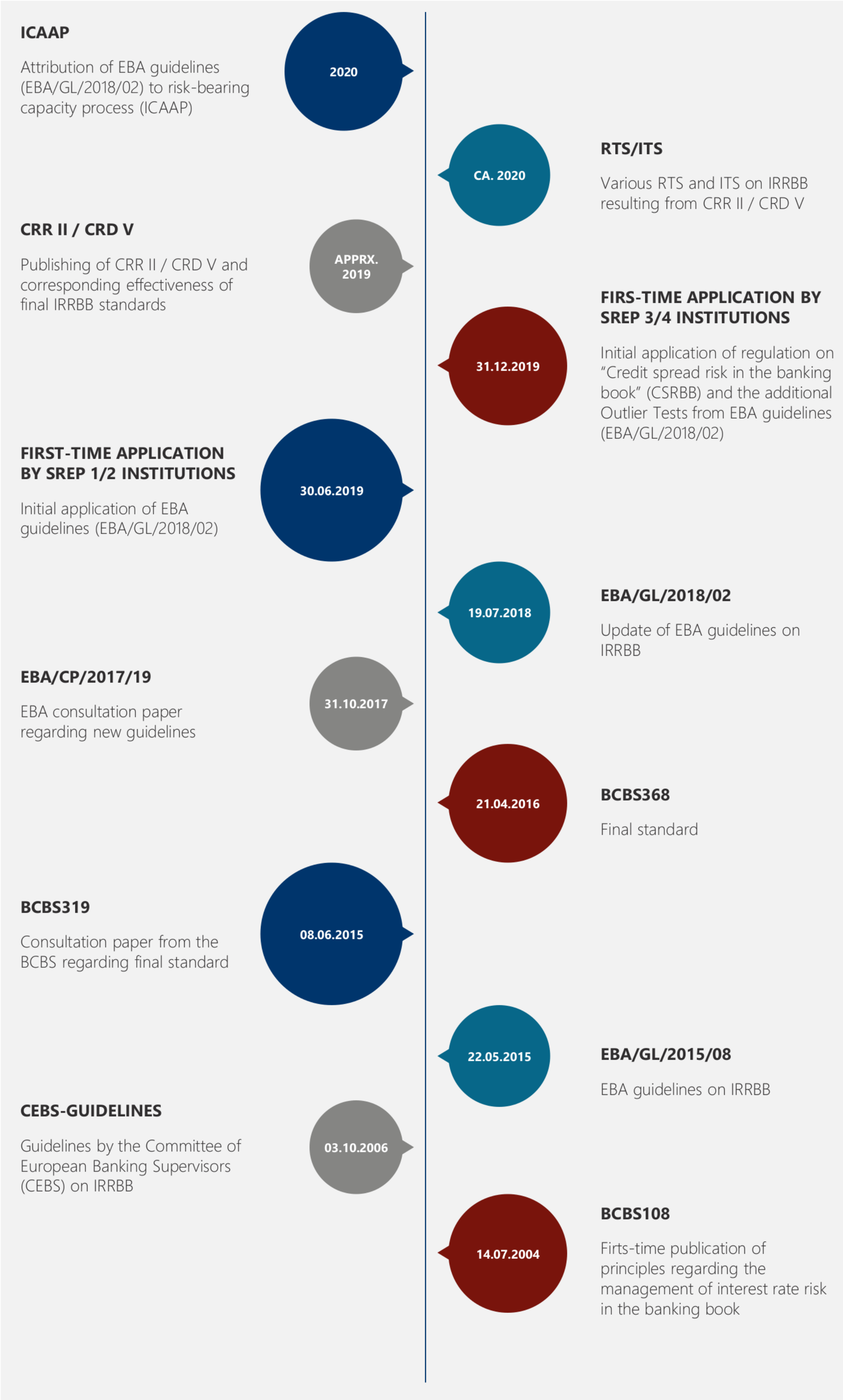

Figure 1: *Timeline of regulatory requirements regarding IRRBB*

A well-documented risk strategy and risk appetite statement for IRRBB needs to be in place which includes institute-specific detailed information on risk measures, metrics and stress scenarios. Additionally, model validation, a topic already discussed in BCBS 368 and now substantiated through the EBA Guidelines, is required to be integrated into governance processes in more detail. After initial validation upon introduction, models are required to be re-validated regularly. Impact analyses, back-testing of input parameters and benchmarking shall be applied in such validations in order to identify and correct potential model deficiencies.

Measurement

IRRBB measures will be required to take the relevant currencies of each individual positions into account separately and aggregate risk over all currencies. For material positions, shock scenarios need to be designed currency-specific. In low interest rate environments, negative interest rate scenarios are to be applied. EBA urges institutions to not only rely on regulatory risk measures for IRRBB but also develop individual tailor-made methods for estimating IRRBB. Risk measurement has to occur at least quarterly and the frequency shall be increased in times of high interest rate volatility.

Supervisory Outlier Test

Previously dubbed *supervisory standard shock* the methodology of the SOT remains unchanged despite its new label. Institutions need to calculate effects of a 200bp parallel shift of the term structure on economic value of equity (EVE). However, reporting requirements are adjusted such that competent authorities are to be informed as soon as the SOT results in a decrease in EVE larger than 20% of Own Funds.

In addition to the SOT, all six shock scenarios from BCBS 368 are now included in the EBA Guidelines. If any one of these leads to hypothetical declines in EVE of more than 15% of CET-1, competent authorities are to be informed. For institutions of categories SREP-3 and SREP-4 these limits become effective as of 31 December 2019. EBA has implemented the following shock scenarios in its final Guidelines:

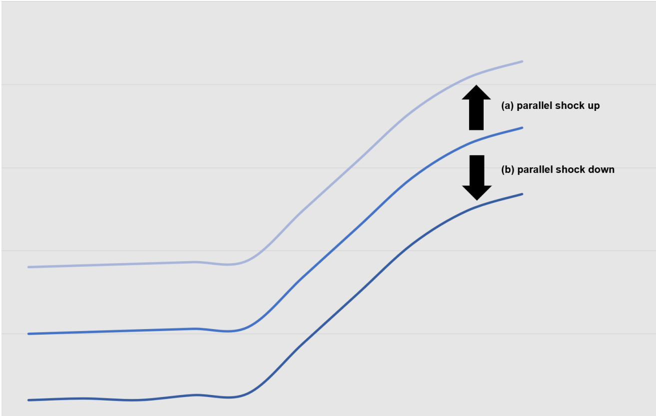

Figure 2: *(a) parallel shock up, (b) parallel shock down*

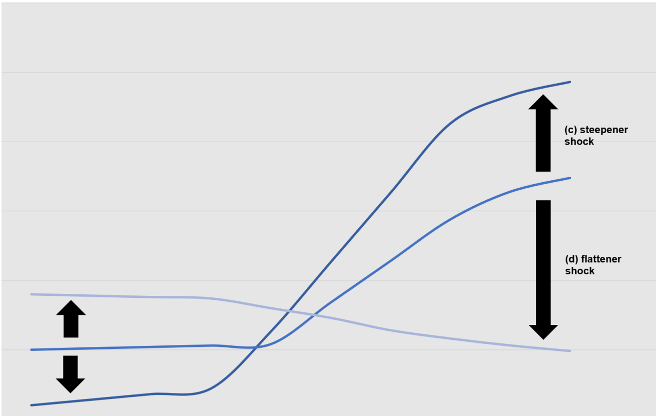

Figure 3: *(c) steepener shock (short rates down and long rates up), (d) flattener shock (short rates up and long rates down)*

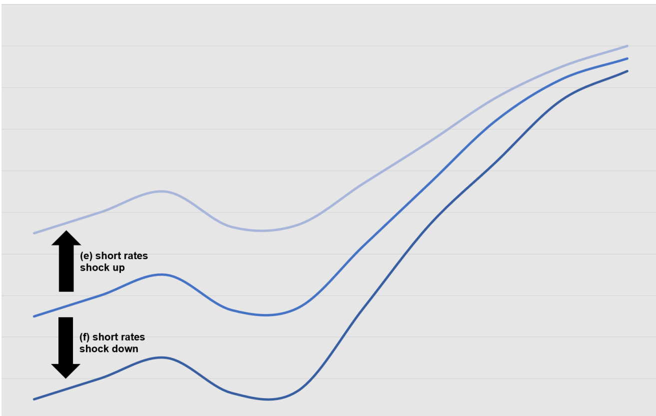

Figure 4: *(e) short rates shock up, (f) short rates shock down*

Depending on the size of positions in different currencies, all shock scenarios need to be calculated currency-specific. Magnitude of the shock is estimated from historical data between the years 2000 and 2015 for various tenors.

All scenarios are to be calculated subject to certain principles. Institutions with an NPE-Ratio of 2% or more must consider these NPEs interest rate sensitive instruments. Furthermore, the treatment of commercial margins and other spread components needs to be consistent with the institutions internal management of interest rate risk in the non-trading book. An interest rate floor of -100bp is applied to short term rates which gradually increases by 5bp per year until it reaches 0% for terms of 20 years or longer.

The adequate implementation and application of these shock scenarios to individual portfolios requires significant effort by institutions. Despite the apparent minor changes and extensions to the guidelines when compared with the consultation paper, uncertainties about correct interpretation of the guidelines remain. Germany-based institutions need to anticipate additional complications when establishing new review processes in line with both SREP and German bank regulation according to MaRisk.

About Finbridge

Finbridge is an independent specialised consultancy to financial services. With over 90 highly qualified consultants, Finbridge offers tailor-made implementation approaches throughout the entire process chain. Finbridge supports banks and financial services successfully in designing and implementing change processes resulting from new regulatory requirements, innovative financial products or adjustments to business models in risk controlling, regulatory reporting, trading and settlement.

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