New Consultation Papers on IRRBB and CSRBB with Significant Impact

December 2021

New requirements with respect to interest rate and credit spread risks in the banking book

Summary

The European Banking Authority (EBA) published three consultation papers on interest rate risk (IRRBB) and credit spread risk in the banking book (CSRBB) on 02 December 2021. The consultation papers are relevant for all banks in the EU. They complement - in line with CRR II / CRD IV - the regulatory framework for IRRBB and CSRBB. The consultation package includes:

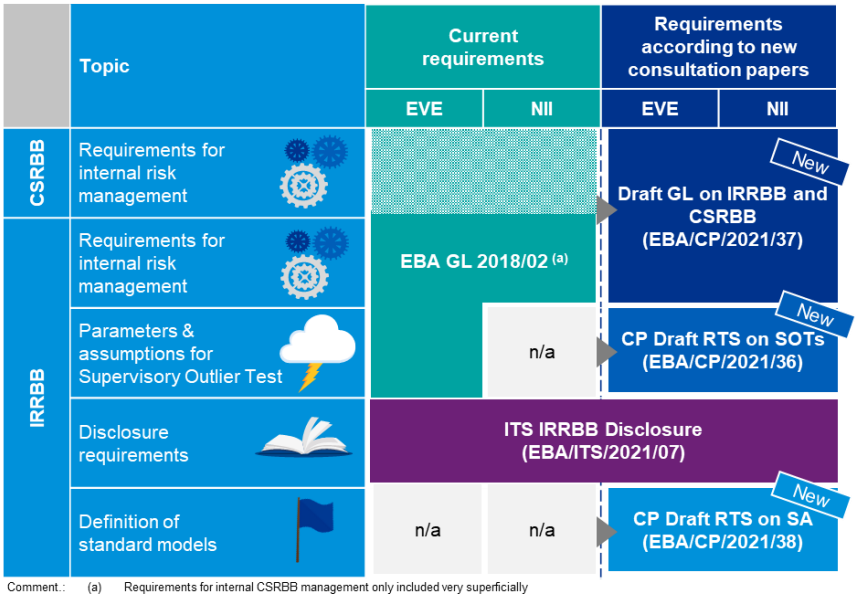
I. an updated guideline on the **internal management of IRRBB and CSRBB**, which will replace EBA/GL/2018/02 upon finalization;
II. technical standards which update the **standard outlier test** for **Economic Value of Equity (EVE)** and introduce a new outlier test and outlier criteria for **Net Interest Income (NII)**;
III. technical standards to introduce two new **standard models for EVE and NII**, which can be required to be implemented by supervisors if internal methods and models are deemed not to be adequate.

Along with the new implementing technical standard on IRRBB disclosure (EBA/ITS/ 2021/07), the papers will form the new basis for the measurement, management, and disclosure of IRRBB and CSRBB. The consultation period ends on April 04, 2022. Based on previous experience, we expect the new guidelines to come into effect towards the end of 2023.

I. Updates for the internal management of IRRBB and CSRBB

The new consultation paper for the internal management of IRRBB and CSRBB **establishes credit spread risk in the banking book as a separate risk category** alongside interest rate risk in the banking book, for which similar governance, risk measurement, management, validation, and IT requirements must be met.

The EBA defines CSRBB as the risk that **economic value <u>or</u> net interest income** will vary due to market-wide spread changes without any change in credit quality of the underlying debtors. Idiosyncratic risks are generally not included in the definition (but may be included if this leads to more conservative risk figures). In the definition of CSRBB, the EBA does not limit the scope to bonds/securities held as assets, but generally includes **all on-balance sheet and off-balance sheet positions** that may have an impact on EVE or NII (incl. fair value effects). Accordingly, all positions in the banking book



must be analyzed regarding their credit spread sensitivity and an exclusion of positions must be explicitly justified. **Assets measured at fair value** hereby represent the **minimum scope of the considered portfolio.**

Requirements regarding the identification and measurement of **CSRBB** are defined **analogously to IRRBB**. Credit spread risks must be measured regularly from a present value (economic value of equity, EVE) and periodic (net interest income, NII) perspective. The methods must be validated regularly and incorporated into the model risk framework. According to the new EBA definition, the NII perspective now includes valuation effects for positions accounted at fair value (FVOCI & FVPnL) in addition to risks to interest income and expenses. Thus, "**Net Interest Income" (NII) is defined as total earnings, both for CSRBB and IRRBB**. The new definition of the NII perspective, which initially appears unusual from an accounting point of view, allows the EBA to formally stay within CRD and CRR mandates (where NII is mentioned) while still setting a clear focus on total earnings. In this respect, limiting and managing net interest income risks must always take valuation effects into account.

Few further aspects have changed for the internal management of the IRRBB, apart from the expanded definition of the NII. The requirements of EBA/GL/2018/02 are still in effect. There are some clarifications which reflect the findings of the supervisory authorities from regulatory practice. This includes a stronger focus on a forward-looking EVE as well as the extension of the limit on the average maturity of deposit models (5 years) to the internal risk measurement. In addition, it is mentioned that going forward there will be a greater focus on diversification assumptions between IRRBB and CSRBB (as well as other risk types), and that these will need to be appropriately validated and stressed.

II. Regulatory Standard Outlier Test and Outlier Criteria

For the first time the new technical standards for the Standard Outlier Tests (SOT) include **a standard outlier test and outlier criteria for the net interest income (NII) perspective**. The NII risk for the parallel up / down scenario is determined, assuming a 1-year horizon and a constant balance sheet. The EBA will still decide whether valuation effects (FVOCI / FVPnL) are to be considered in the calculation. In addition, two alternatives are currently under discussion for the outlier criterion: (1) the delta NII in relation to Tier 1 capital and (2) the ratio of the shocked NII to a baseline NII, adjusted in each case for pro rata administrative costs incurred in generating the NII. The decision between the alternatives will be made by EBA after the consultation phase.

The new technical standards for the **present value SOT** contain only **minor changes**. Going forward outlier criterion will be exclusively based on the 15% threshold of the Delta EVE in relation to tier 1 capital, as it is currently the norm. The calculation is based on the known 6 BCBS scenarios. The outlier criterion set at 20% of own funds was excluded from the consultation paper. In addition, the consideration of positive changes in present value in individual currencies has been slightly changed.

Going forward, a new floor for stressed interest rates will apply to both economic value and net interest income SOTs, starting at -150 basis points for the overnight interest rate and rising linearly to zero over 50 years, which is significantly lower than the current floor

Furthermore, the results of the SOT are to be disclosed in the disclosure on IRRBB on an annual or semi-annual basis (see EBA/ITS/2021/07).

III. Standard models for EVE and NII

The new technical standard specifies, for the first time in the EU, clear standard approaches/standard models for **economic-value and net interest income measures for IRRBB**. **Supervisors may require** banks **to apply the standard approaches** if the internal models for IRRBB risk measurement are deemed to be inadequate. The standardized approaches are currently not intended to replace the internal models in general. The EBA still requires (further) developments of bank specific internal models for risk measurement. Moreover, in contrast to numerous Pillar I standard approaches, the application of the IRRBB standard models is not mandatory for all banks and is not used to derive floors for

EBA will decide on some options

To be determined by EBA

1 Option A: **Delta NII** relative to **tier 1 capital** (comparable to SOT EVE)

Option B: NI after interest rate shock relative to baseline NII; both after deduction of **attributable admin. expenses**

2 w/o FV / with FV: In addition to narrow NII **(no) inclusion of fair value changes** in FV positions

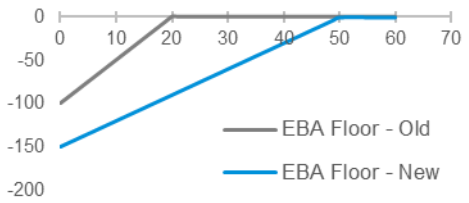
Prelim. calibration of outlier thresholds

Derivation of preliminary thresholds based on data collected in QIS, end-2020

2 FV changes	1 Options for calculation A	B
No	-2.5%	-35%
Yes	-3.0%	-30%

KPMG's educated guess

New floor for risk free rates



New definition of EBA floor has to be applied to interest rate shocks **for EVE as well as for NII.**

(Pillar II) capital requirements from IRRBB. The new **economic value standard model for IRRBB** is very much **based on the proposed model of the BCBS 368 paper**, with three separate pillars / approaches for deterministic products, modeled products, and an add-on for automatic interest rate options. Regarding **net interest income, the EBA has developed its own model** assuming a constant balance sheet, historically derived margins, and clear model / methodology assumptions. In this context, the net interest income perspective also includes valuation effects (FVOCI & FVPnL). For both models, there are also simplified assumptions for small and non-complex institutions.

An interesting observation going forward will be the **extent to which the supervisory authorities aim to use the standard models**. However, the standard models may already be of interest to banks as challenger models (e.g. in validation) as well as to provide a better understanding of the approach and audit practice of the supervisory authorities.

Recommendations

Based on experience, we expect that the final EBA papers will not look fundamentally differently than the consultation papers.

Accordingly, we recommend banks prepare at an early stage and take into account aspects which require a larger effort to implement. This includes in particular:

- **Institution-specific gap analyses** against the requirements for the internal management of IRRBB and CSRBB, to assess the need for changes and extensions;
- Structured, documented and institution-specific **scope analysis for CSRBB** to assess for every position whether market wide credit spread changes lead to EVE or NII risk;
- **Design of the future CSRBB management**, including the integration of CSRBB into the periodic risk methods and models;
- **Test calculations** for the new SOT for periodic risks to classify themselves according to Outlier criteria and future disclosure requirements;
- **Application of the standard models** for EVE and NII as challenger / validation models and to develop a better understanding of the supervisors' expectations.

According to our market overview, the identification processes for CSRBB and the integration of CSRBB into the periodic perspective represent a major challenge for European banks. Early preparation and active support of the consultation phase can ensure timely implementation of the requirements after publication of the final guidelines..

Next steps

The **consultation period ends on April 4, 2022** and allows institutions to address any questions or ambiguities. Based on past consultation phases of the EBA on IRRBB and similar topics, we expect the final guideline to be published by the end of 2022, and an implementation phase by around the end of 2023.

Furthermore, **the European Central Bank (ECB) has also made clear in its priorities from 2022-2024 that IRRBB and CSRBB are of high importance** for supervisors. Accordingly, we expect increased pressure on financial institutions to develop their internal methods and procedures.

Feel free to contact us!

Our teams of experienced experts in Risk & Treasury will be happy to support you in preparing for the new requirements. Whether you need a gap analysis, a CSRBB scope analysis for your bank, or the application of standard models: Our experts for IRRBB and CSRBB will support you in preparing for the new requirement.

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