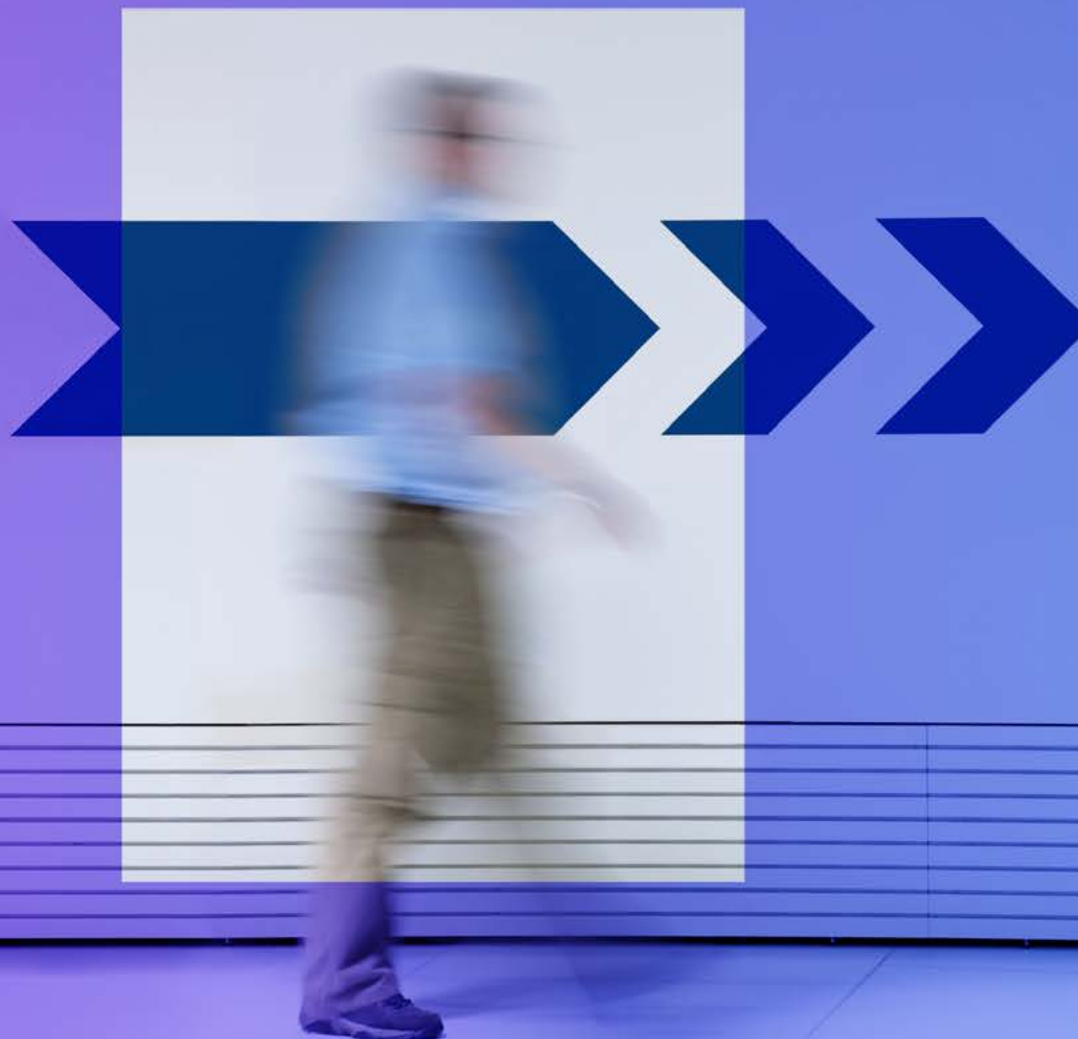




Changing direction under time pressure

**New regulatory package for IRRBB and CSRBB will
have a significant impact on financial institutions**
Whitepaper



November 2022

Finalization of new requirements with respect to interest rate and credit spread risk in the banking book

Summary

The European Banking Authority (EBA) finalized the new guidelines and technical standards on interest rate risk (IRRBB) and credit spread risk in the banking book (CSRBB) on 20 October 2022. The new requirements are relevant for all banks in the EU and will replace the EBA/GL/2018/02 guideline. The regulatory package includes:

- I. An updated guideline on the **internal management of IRRBB** (valid from 30.06.23) and **CSRBB** (valid from 31.12.23);
- II. Technical standards on the **supervisory outlier test (SOT) for Economic Value of Equity (EVE)** and introduction of a new outlier test and outlier criteria for **Net Interest Income (NII)** (valid 20 days after publication by the EU Commission);
- III. Technical standards to introduce two new **standard models for EVE and NII**, the implementation of which can be required by supervisors if internal methods and models are not deemed adequate.






In combination with the implementing technical standard on IRRBB disclosure (EBA/ITS/2021/07), the papers will form the basis for the measurement, management, and disclosure of IRRBB and CSRBB.

The timeline for implementation is as follows:

- a. Requirements regarding the internal management of IRRBB are to be implemented by 30 June 2023
- b. Requirements regarding **CSRBB** have an **extended implementation period until 31 December 2023**
- c. The new SOT for EVE and NII takes effect **20 days after its confirmation by the EU Commission and publication** in the Official Journal of the European Union. We expect timely inclusion into the regulatory reporting by the ECB.

The EBA therefore provides institutions with a relatively short time span for implementation, especially with respect to the new requirements for CSRBB.

Figure 1:
Overview of the regulatory framework

	Topic	Current requirements		Requirements according to new regulatory framework	
		EVE	NII	EVE	NII
CSRBB	Requirements for internal risk management 			GL on IRRBB and CSRBB (EBA/GL/2022/14) Implementation by 30.06.2023 (IRRBB) & 31.12.2023 (CSRBB)	
	Requirements for internal risk management 	EBA GL 2018/02 (a)			
IRRBB	Parameters & assumptions for Supervisory Outlier Test 		n/a	RTS on SOT (EBA/RTS/2022/10) Implementation within 20 days of its confirmation by the EU Commission	
	Disclosure requirements 	ITS IRRBB Disclosure (EBA/ITS/2021/07)			
	Definition of standard models 	n/a	n/a	RTS on SA (EBA/RTS/2022/09) Implementation only on demand by the regulator	

Comment.: (a) Requirements for internal CSRBB management only included very superficially.

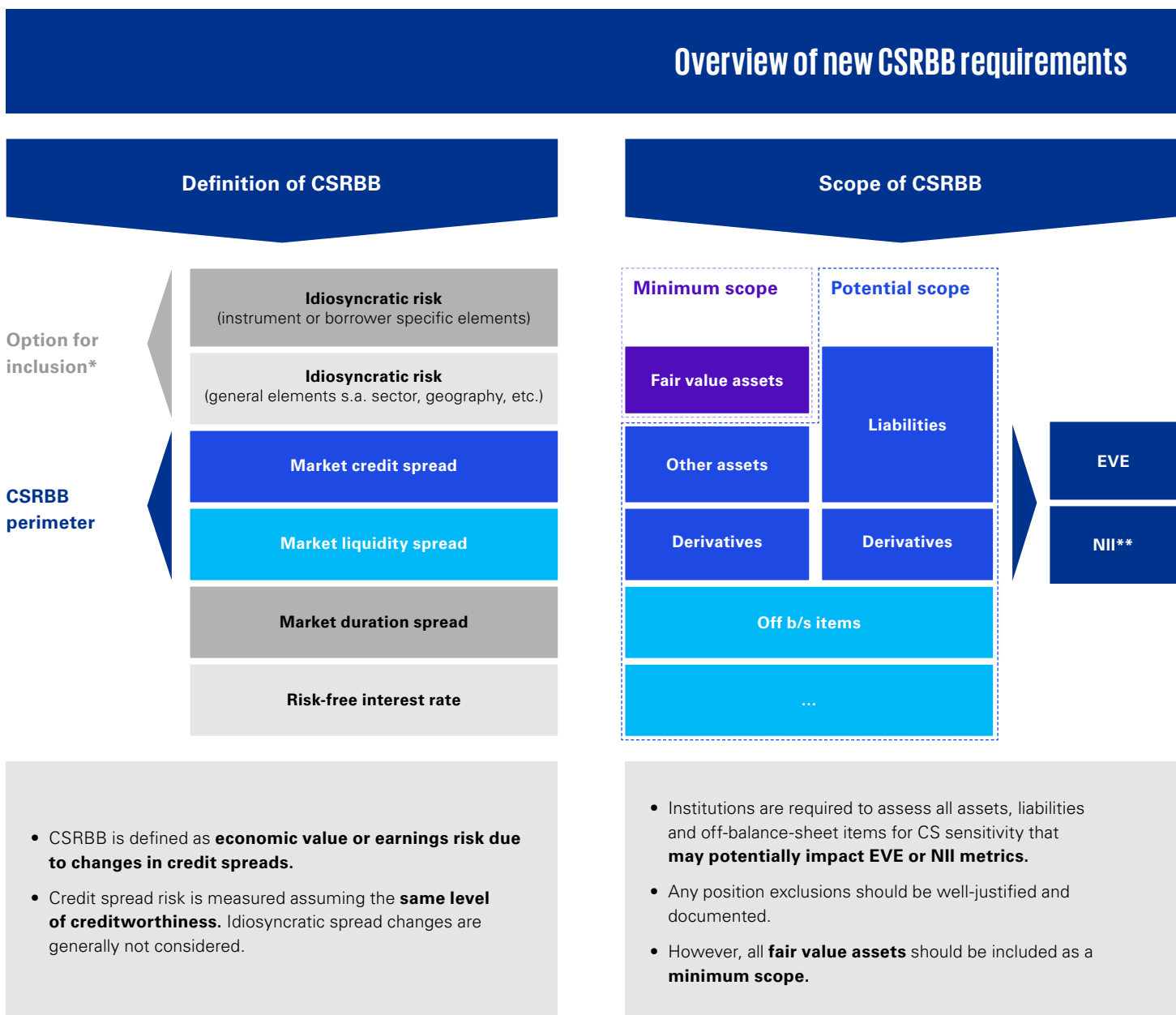
Source: KPMG in Germany, 2022

I. Updates for the internal management of IRRBB and CSRBB

The new requirements for the internal management of IRRBB and CSRBB **establish 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.

CSRBB is defined as the risk that **economic value or 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).

Figure 2:
Overview of new CSRBB requirements



* Institutions may include idiosyncratic credit spread components for the monitoring of CSRBB as long as it is ensured that the measures will yield more conservative results.

** Risk for NII is defined as risk for earnings risk incl. FVPL and FVOCI

In the definition of CSRBB, the EBA explicitly 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 analysed 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**.

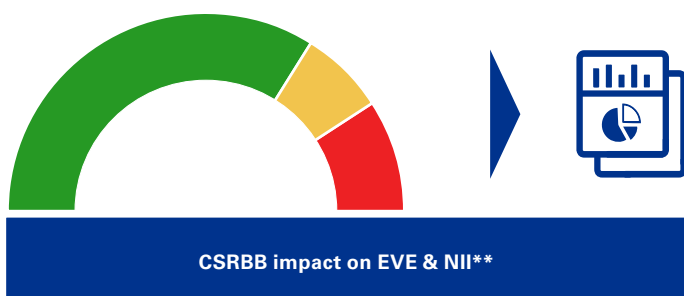
Requirements regarding the identification and **measurement of CSRBB** are defined **analogously to IRRBB**. Credit spread risks must be measured regularly from a present value (economic value of equity, EVE) and periodic (net interest income and accounting effects) perspective. The methods must be validated regularly and incorporated into the model risk framework. According to the new guideline, the aim is to manage the earnings perspective, which explicitly includes valuation effects (FVOCI & FVPnL) in addition to risks for net interest income and expenses.

In the new guideline, the focus is thus shifted more towards the management of total earnings, which affects both the CSRBB and the IRRBB. Here, the supervisor puts emphasis on a comprehensive earnings perspective. Therefore, limiting and managing periodic risks should also take valuation effects into account.

Few changes have been made for the internal management of the IRRBB, apart from the expanded definition of the NII. The requirements of EBA/GL/2018/02 remain largely unchanged. There are a few refinements 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) for the internal risk measurement. Compared to the consultation paper the EBA clarified that the investment assumptions for non-maturity deposits (NMDs) will be analysed with greater scrutiny going forward, especially against the backdrop of the currently changing interest rate market.

In addition, the guidelines mention 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.

CSRBB Management



- Definition of **risk appetite** is required for the impact of fluctuating credit spreads on both “NII” (i.e. earnings) and EV.
- **Validation** of CSRBB measurement methods and assumptions
- At least **quarterly reporting** of CSRBB exposure
- Roughly similar requirements as for IRRBB

Source: KPMG in Germany, 2022

II. Regulatory Supervisory Outlier Test and Outlier Criteria

For the first time the new technical standards for the Supervisory Outlier Tests (SOT) include **a supervisory outlier test and outlier criteria for the net interest income (NII) perspective.**

The NII risk for the parallel shift scenario is determined, assuming a 1-year horizon and a constant balance sheet. For the SOT the EBA thereby restricted itself to a “narrow” definition of the periodic view, including only the “pure” net interest income and ignoring the fair value effects for now.

One argument for this narrow view of the NII was a greater comparability across banks. The NII will therein be viewed in relation to the Tier 1 capital of a bank. If the NII loss in the scenario, compared to the base scenario, exceeds 2.5% of Tier 1 capital, the institution will be viewed as displaying an increased periodic risk.

The new technical standards for the **present value SOT** contain only **minor changes** to the current standard shock. Going forward, the outlier criterion will be exclusively based on the 15% threshold of the delta EVE in relation to Tier 1 capital, as is currently the norm. The calculation is based on the known 6 BCBS scenarios. The outlier criterion set at 20% of own funds is no longer applied. 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 reported in the disclosure on IRRBB on an annual or semi-annual basis (see EBA/ITS/2021/07).

III. Standard models for EVE and NII

For the first time in the EU, the new technical standard specifies 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) development of institution-specific internal models of risk measurement by banks. 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 (Pillar II) capital requirements for IRRBB.

The **economic value standard model for IRRBB** is therein very much **based on the proposed model of the BCBS 368 paper**, with three separate pillars/

approaches for deterministic products, modelled 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 & FVPL). For both models, there are also simplified approaches for small and less complex institutions.

The **extent to which the supervisory authorities will demand the usage of the standard models remains to be seen.** However, the standard models may already be of interest to banks to use 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.

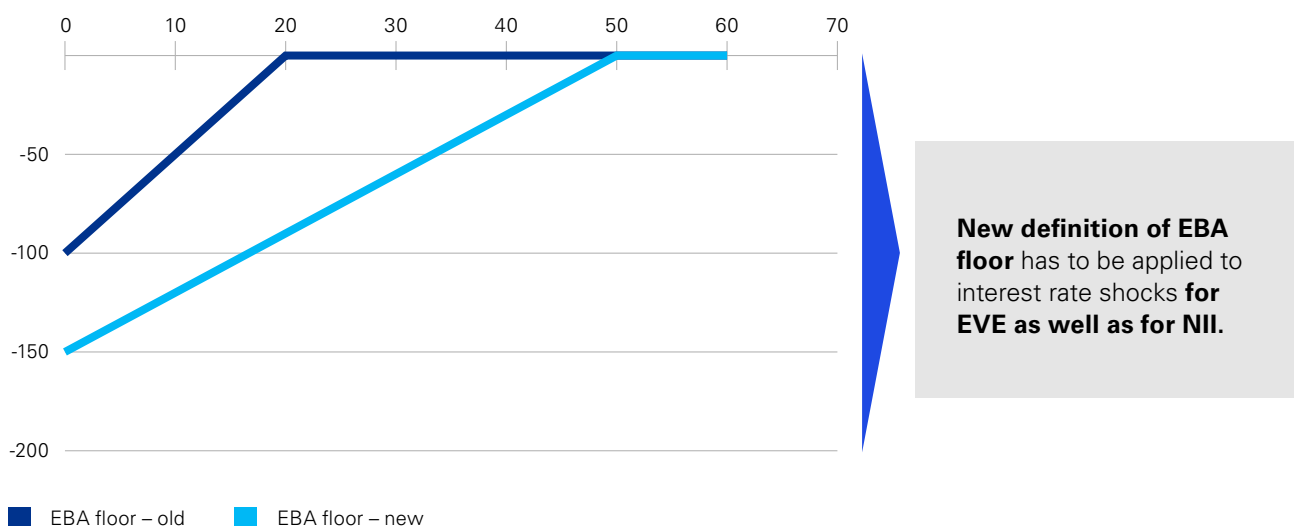
Recommendations

The EBA only allows for a rather short implementation period for EBA/GL/2022/14 in respect of internal risk management, with 8 months for IRRBB and 14 months for the new CSRBB requirements. The exact timeline for the new SOT is still somewhat uncertain, but we expect their quick inclusion into the regulatory reporting after confirmation by the EU Commission.

Considering the expected changes needed, especially to establish CSRBB as a separate risk category alongside IRRBB, we recommend swift management action.

Figure 3:

New floor for risk-free rates



Source: KPMG in Germany, 2022

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 these 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 banks.

Considering the short implementation phase, it will be of utmost importance to leverage existing IRRBB methods as well as processes for CSRBB in order to quickly and efficiently address the new requirements.

Next steps

The implementation of the new requirements for the internal management will take effect on 30 June 2023 for IRRBB and 31 December 2023 for CSRBB, respectively. The requirements for the SOT will take effect 20 days after confirmation by the EU Commission and subsequent publication in the Official Journal of the European Union. A timely inclusion of the new SOTs into ECB regulatory reporting is to be expected.

Furthermore, **the European Central Bank (ECB) has also made clear in its priorities for 2022–2024 that IRRBB and CSRBB are important** for supervisors. Accordingly, we expect increased pressure on financial institutions to develop their internal methods and procedures. Based on our experience, this will include a number of on-site inspections based on the new regulatory package.

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 requirements.

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