Consultation of the new standards for IRRBB & CSRBB

The final chapter?

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Content

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Abbreviations

BCBS	Basel Committee on Banking Supervision
CSRBB	Credit Spread Risk in the Banking Book
EBA	European Banking Authority
EVE	Economic Value of Equity
IRRBB	Interest Rate Risk in the Banking Book
LSI	Less significant Institution
NII	Net Interest Income
NMD	Non Maturity Deposit
NPE	Non Performing Exposure
RTS	Regulatory Technical Standard

01. Introduction

On December 2, 2021, the EBA published the eagerly awaited consultation versions of the new IRRBB guidelines, including the requirements for CSRBB [2], and the two RTSs on standard methods [3] and the outlier test [4], as mandated by CRD5 [7]. The consultation period runs for four months until April 4, 2022. The three published papers contain comprehensive innovations and represent the final step in the implementation of the Basel requirements from 2016 [6]. Key innovations are:

- The requirements regarding CSRBB have been significantly expanded, especially regarding governance.
- Standard methods and simplified standard methods for the EVE and NII views were published.
- An outlier test for the NII view was introduced.

After the end of the consultation phase, the guidelines will be translated into the official EU languages and assessed by the national supervisory authorities about their degree of compliance. No date has yet been given for the final entry into force of the new requirements.

The extent to which these papers actually represent the final chapter on IRRBB regulation will be examined in more detail on the following pages. Sections 2-4 are each devoted to one of the consultation papers and present the main innovations. A general summary is then given in the last section.

02. Guidelines for IRRBB & CSRBB

The consultation draft [2] of the new EBA Guidelines on IRRBB and CSRBB is intended to replace the previous 2018 EBA IRRBB Guidelines [1]. The main features in the draft are the requirements on the adequacy of internal IRRBB methods and on CSRBB. In contrast, the general requirements on IRRBB have only been adjusted slightly. The rules on the present value supervisory outlier test have been removed from the guideline and now form the basis of a new stand-alone RTS [4] on this topic.

According to the EBA, the new guidelines are the final implementation of the Basel guidelines [6] regarding internal methods for IRRBB and CSRBB.

2.1 Updates for IRRBB

IRRBB: only minor adjustments

Only minor adjustments have been made to the existing IRRBB requirements. In purely conceptual terms, the term NII is used again, although this now includes present value effects. In addition, the restrictions resulting from the use of a run-off balance sheet are to be analysed in the present value view, instrument-specific floors are to be considered in detail and inflation risks are to be modeled independently of scenarios. The modeled maturity of NMDs should be a maximum of 5 years on a weighted average basis per currency. As this requirement only applies as an average across all segments, this represents a simplification compared with the original version. Finally, diversification assumptions regarding CSRBB are to be validated.

2.2 Adequacy of internal IRRBB methods

Appropriate = Compliant with guidelines

The comments on the adequacy of internal IRRBB methods are limited to compliance with the guidelines. In addition, the satisfactory coverage of all material (sub) risks is emphasised, as well as the sufficient calibration and back-testing of the (model) parameters used. In case of insufficient internal methods, the respective standard method can be imposed on the institution. This requires institutions to pay more attention to the issue of plausibility checks and validation of IRRBB models in EVE and NII terms.

2.3 Alignments for CSRBB

In principle, the requirements for CSRBB have been aligned with those for IRRBB. This applies to governance and strategy, risk framework and responsibilities, policies and processes, and (modeling) assumptions. At the same time, however, there are significantly fewer requirements regarding methods, limitation, validation and reporting as well as derivatives and hedging.

CSRBB includes both EVE and NII, but only refers to the market-related liquidity and credit spread. Idiosyncratic risk and differentiation by sector are generally excluded but can be included if conservatism is maintained. Migration risk is not part of CSRBB.

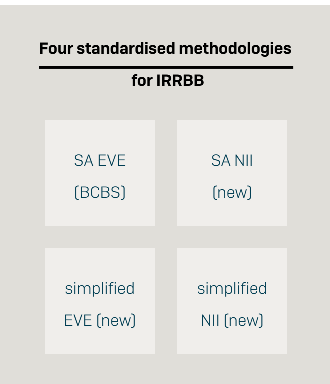
CSRBB: No ex-ante exclusion of positions

A priori, no positions may be excluded from the CSRBB assessment: All non-defaulted asset and liability positions must be assessed for sensitivity to credit spread risks regardless of their accounting treatment, and any exclusions made must be justified and documented. Fair value positions sensitive to credit spread movements must not be excluded per se.

In principle, it is possible to offset diversification effects of CSRBB with IRRBB, but a separate consideration of CSRBB is mandatory.

03. Standardised methodology for IRRBB

The consultation paper on the new RTS [3] describes four standard methodologies for IRRBB: one for the present value view, one for the income view ("standardised approach"), and simplified variants of the previous two methods ("simplified standardised approach"). No standardised methodologies have been provided for CSRBB to date.



The EVE standardised approach essentially corresponds to the Basel Committee's model published in 2016, whereas the NII standardised approach was newly developed by the EBA (in the absence of a BCBS template) but builds on the present value method and uses the same modeling assumptions.

The methods tend to target LSIs in this context. However, supervisors can impose the use of the standard method on institutions in case of deficiencies in the internal methods. This is essentially an economic disadvantage since the model parameters of the standard methods are conservatively calibrated. The simplified standard methods, on the other hand, further reduce the complexity of calculations, as they work with fewer individual assumptions and input data but are still somewhat more conservative in their results than the "regular" standard methods.

3.1 Standardised methodology for EVE

The approach is comprehensively based on the 2016 BCBS guideline, i.e., in the classification of cash flows by fixed interest rate into fixed maturity bands (per currency) and discounting with an average discount factor per maturity band. Behavioral and automatic options are treated within a standardised, predefined framework with partial use of the institution's own methods and assumptions.

Only minor additions to the BCBS template can be identified, such as the application of the 2% materiality limit to additional types of positions (e.g., non-maturing deposits, prepayment options) besides NPE.

3.2 Standardised methodology for NII

The NII standard method is based on a constant balance sheet assumption and an observation horizon of at least one year. The specifications for modeling cash flows largely correspond to specifications for EVE, but are extended by several points and thus achieve a significantly higher level of complexity.

For each scenario, the expected interest income is calculated for the observation horizon. This consists of three contributions, which are shown in table 1.

In addition to the interest rate and margin components, which are complex to determine, add-ons are provided for automatic options, fair value changes and basis risks.

Table 1: Contributions of the interest income per scenario in the standardised methodology for NII

Interest rate forecast (market interest rate)	• For this calculation, the cash flows must additionally be broken down according to the reference term
Interest rate forecast (margin)	• Classification of cash flows according to contractual maturity (margin lock-in) instead of interest rate lock-in • Calculation of margins based on margins for new business in the last year (broken down by product type/customer group and country) or on current market prices
Fixed interest rates and margins	• Calculation until end of fixed interest rate period or end of contractual term

04. Supervisory outlier test

The regulations on the supervisory outlier test have been removed from the EBA Guideline and summarised in a separate RTS [4]. The main innovations are the abolition of the classic +/-200bp shocks, the inclusion of NII scenarios for the first time, and the adjustment of the interest rate floor.

4.1 Adjustments for EVE

As expected, the classic +/- 200bp scenarios are finally discontinued with the new RTS. They will be replaced in the EVE calculation by the six scenarios (parallel up/down, steepener/flattener, short rates up/down) previously used for the early warning indicator. The reporting criterion in the event of a scenario loss of more than 15% of Tier 1 capital is retained.

New interest rate floor takes effect from -150bp

In the future, the interest rate floor in the down-shift scenarios will only take effect at -150bp for immediate maturities and increases linearly in annual 3bp steps until it remains at 0bp from 50 years onwards. With the old floor, the corresponding values were -100bp, 5bp/year and 20 years. Due to the continuing low interest rate environment, an adjustment was necessary here.

4.2 Introduction of scenarios for NII

Two scenarios and a one-year horizon

For the first time, an outlier test is also introduced for the NII side. Compared with the EVE view, however, this only covers the two scenarios with parallel shocks, with the interest rate floor applying to the down-shift scenario in exactly the same way. The use of a simulation period of one year with a constant balance sheet is mandatory.

In contrast to the EVE, no final decision regarding the reporting criterion for a large NII decline has been reached in the present consultation. The EBA presents two possible measures, one being a capital measure analogous to the EVE side and the other a cost measure. The final decision on which of the two measures will be the future reporting criterion will be based on feedback from the consultation and Basel III monitoring.

Furthermore, the definition of the NII to be used for the outlier test is being discussed. A distinction is made between two variants. On one hand, a proposal to limit the determination of the NII to the difference between interest income and interest expense. On the other, changes in fair value, such as pull-to-par effects for securities, could also be regarded in the calculation of the NII.

Decision on outlier criterion and fair value changes open

Even though the EBA prefers the first option due to better comparability between institutions, the final decision will also be made considering the results from the consultation. It should be noted that the variant chosen to determine the NII will have an impact on the level above which an NII decline is considered large.

05. Summary

The three EBA publications contain fundamental innovations as well as adjustments that in some cases go significantly beyond the expected requirements.

With reference to governance, the requirements for CSRBB have been aligned with those of IRRBB in many respects, but otherwise remain very generic. Although reference to the market is emphasised, idiosyncratic risks and particularly, a differentiation of the sector are excluded; which makes operationalisation for securities significantly more difficult.

As expected, the new standard methods for the EVE view are based on the Basel approach of 2016. The specifications for the NII view are new and significantly more complex than anticipated. The data requirements are significantly higher than for the present value view and the consideration of margins and the definition of three different add-ons increase the implementation effort considerably.

The standard methods allow conclusions to be drawn about the minimum requirements for internal methods. This could also be relevant for large institutions, for which the standard methods will generally remain a threat. For LSIs, implementation into national law will still take some time.

Also, for supervisory outlier tests, apart from the new (still open) limits for NIIs, little will change for SIs; they already report comparable results as part of the quarterly STE reporting. For LSIs, these requirements are fundamentally new and will generate some implementation effort.

Conclusion

The consultation provides the long-awaited concretisation of regulation for interest rate risk in the banking book. However, there is still substantial need for discussion and adjustment in many areas. Institutions should therefore make full use of the current consultation.

Due to the further potential impact of the COVID19 pandemic and the existing low interest rate environment, the topics of IRRBB and CSRBB are among the key supervisory priorities for the ECB in the coming years [5]. In this context, the ECB pays particular attention to a sound risk management framework that governs the assessment, management and monitoring of IRRBB, and takes timely remedial action when deficiencies are identified. Institutions should prepare for this.

Do you have any further questions?

We would be happy to discuss the new requirements with you in detail and analyse the implications for your company.

Appendix

[1] EBA: Guidelines on the management of interest rate risk arising from non-trading book activities, EBA/GL/2018/02, 18.07.2018

[2] EBA: Consultation Paper: Draft Guidelines issued on the basis of Article 84 (6) of Directive 2013/36/EU specifying aspects of the identification, evaluation, management and mitigation of the risks arising from potential changes in interest rates and of the assessment and monitoring of credit spread risk, of institutions' non-trading book activities, EBA/CP/2021/37, 02.12.2021

[3] EBA: Consultation Paper: Draft Regulatory Technical Standards specifying standardised and simplified standardised methodologies to evaluate the risks arising from potential changes in interest rates that affect both the economic value of equity and the net interest income of an institution's non-trading book activities in accordance with 84(5) of Directive 2013/36/EU, EBA/CP2021/38, 02.12.2021

[4] EBA: Consultation Paper: Draft Regulatory Technical Standards specifying supervisory shock scenarios, common modelling and parametric assumptions and what constitutes a large decline for the calculation of the economic value of equity and of the net interest income in accordance with Article 98(5a) of Directive 2013/36/EU, EBA/CP/2021/36, 02.12.2021

[5] ECB: Supervisory priorities and risk assessment for 2022-2024, 2021

[6] BCBS 368: Interest rate risk in the banking book, 08.06.2016

[7] European commission: CRD V/CRR II, 04.06.2021

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