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Financial Services Risk and Regulation

Hot topic

EBA's final IRRBB guidelines: What does it mean for firms?

Highlights

The EBA's final Interest Rate Risk in the Banking Book (IRRBB) guidelines are the first step in implementing the Basel Committee's 2016 IRRBB Standards at the EU level, and include a number of important changes.

Implementation is scheduled for 30 June 2019, with transitional arrangements for specific provisions until 31 December 2019.

These guidelines are intended to act as a transition to the forthcoming CRD V/CRR2 framework, after which the EBA plans to publish more detailed technical standards on IRRBB.

Background and timeline of developments

In April 2016 the Basel Committee on Banking Supervision (BCBS) published *updated standards on IRRBB*, substantially increasing the rigour required throughout the interest rate risk management process in the non-trading book. Following a consultation process, the EBA took the first step toward implementing these standards at the EU level by publishing the *final IRRBB Guidelines* on 19 July 2018. In addition to these guidelines, the EBA also plans to publish a number of technical standards after the finalisation of CRD5/CRR2.

The IRRBB framework

IRRBB refers to the current or prospective risk to banks' capital and earnings arising from adverse movements in interest rates that affect banking book positions.

IRRBB consists of three main components:

- **Gap risk**, which arises from the term structure of banking book instruments resulting in rate changes impacting instruments at different times.
- **Basis risk**, which relates to the impact of relative changes in interest rates for financial instruments that have similar tenors but are priced using different interest rate indices.
- **Option risk**, which arises from option derivative positions or from optional elements embedded in a bank's assets, liabilities and off-balance sheet items.

The regulatory framework expects banks to take into account the impact on capital and earnings of IRRBB by developing their own methodologies and processes for identification, measurement, monitoring and control of this risk, as part of Pillar 2.

What are the changes?

The BCBS standards on IRRBB provide qualitative and quantitative guidance for institutions on how to identify, measure, monitor and control their IRRBB exposures. Given the BCBS revised its standards in *April 2016*, the EBA decided to revamp its *May 2015 IRRBB guidelines* to take account of the updates in the Committee's revised guidelines.

The updated guidelines amend the 2015 IRRBB guidelines in four main areas: Capital identification, calculation and allocation; the Supervisory outlier test; Measurement; and Governance.

Capital identification, calculation and allocation

The EBA expect firms to set a level of internal capital for IRRBB commensurate with their level of IRRBB and risk appetite in line with its proportionality principle.

The updated guidelines require firms to take into account any potential changes in their economic value (EV) and future earnings capacity that could arise from adverse movements in interest rates. But, the EBA does not expect firms to double-count their internal capital for EV and earning measures.

The EBA also requires firms to take into account any ineffectiveness in hedging on their IRRBB. The updated guidelines explicitly require firms to measure and monitor their IRRBB originated by interest rate derivatives and to monitor their hedging positions. The EBA expects firms to have a clear policy on how they plan to address volatility in EV and Net Interest Income (NII) in case some hedges turn out to be ineffective. However, following feedback during the consultation, it no longer explicitly requires firms to set any risk limits for their hedging strategies.

The updated guidelines also require firms to take into account the impact of embedded losses and embedded gains in their banking books. This means that firms can now take into account any gains from the difference between the current carrying value of balance sheet items and their fair value amount.

In line with the BCBS Standards, the EBA now also expects firms to take account of the potential effect of IRRBB on their dividend distribution policies and any potential risks to their business operations.

In addition, the guidelines explicitly require firms to take into account credit spread risk in the banking book activities (CSRBB). The EBA expects firms to monitor and assess their CSRBB-affected exposures on the asset side of their banking books. We expect future technical standards to provide further clarification on the definition, scope and assessment of CSRBB.

Supervisory outlier test

The 2015 guidelines included a supervisory test which was based on a 'supervisory standard shock' of a sudden and unexpected change in interest rates of +/- 200 basis points, and required supervisors to take action should a firm's EV decline by more than 20% of their own funds. The updated guidelines retain this rule but introduce a new threshold based on the updated BCBS Standards.

The updated guidelines requires firms to calculate the impact of six predefined shock scenarios on their own funds and to inform their supervisor should the decline in economic value exceed 15% of Tier 1 Capital. The EBA expects the second threshold to function as an early warning indicator to trigger an enhanced supervisory dialogue.

This 'Supervisory Outlier Test' recognises the difference between firms in terms of risk profile and complexity of their activities as well as their general approach to measuring IRRBB and grants firms a degree of flexibility, for example on the treatment of commercial margins and other spread components in interest payments in terms.

In another key change to the 2015 guidelines, the EBA has introduced a minimum level for negative interest rates within the supervisory outlier test. Instead of the 0% floor in the 2015 guidelines, the EBA now require firms to apply a interest rate floor for each currency, which may be below zero. The updated guidelines require firms to use a reference rate of -100 basis points and to increase it by 5 basis points per year, eventually reaching 0% for maturities of 20 years and more.

The updated guidelines also allow firms to realise currency diversification benefits. The EBA allows firms to calculate their aggregate EVE change adding together any negative and positive changes in each currency. However, it requires firms to weight the positive changes by 50%.

In addition, the EBA has decided to retain the minimum thresholds of 5% for individual currency and minimum of 90% of the total non-trading book assets or liabilities for material currencies. The EBA plans to assess the impact of these changes and to publish regulatory technical standards after the finalisation of CRD 5/CRR 2.

Measurement

The EBA revised the IRRBB measurement procedures in line with the BCBS Standards. The updated guidelines now include additional details on IRRBB measurement techniques and assumptions. In addition to the details provided for the supervisory outlier test, the updated guidelines now also include more details on how firms should measure their IRRBB exposures on an ongoing basis.

The EBA now expect firms to use currency-specific shock scenarios at least on a quarterly basis, taking account of their all currency exposures. It also require firms to aggregate their IRRBB across different currencies and to take into account the dependencies between interest rates across different currencies.

The updated guidelines now include an explicit provision for institutions to take into account negative interest rate scenarios and any asymmetrical effects on their interest rate sensitive instruments.

The updated guidelines also include a detailed discussion of measurement assumptions. As measurement assumptions can have a material impact on EV and NII, the EBA requires firms to identify the risks that might arise should their assumptions prove incorrect.

Governance

The updated guidelines introduce new requirements for governance of IRRBB and improve the existing standards for internal controls and model validation.

The EBA expects firms to appropriately assess the level of IRRBB resulting from new products and activities. It expects firms' senior management to be responsible for monitoring and management of IRRBB, and sets the conditions under which this duty may be delegated.

The EBA now expects firms to take account of their model risk for IRRBB in a formal policy process and to reflect this in their ICAAPs. It also require firms to have their IRRBB measurement models reviewed and validated independently.

IT systems should provide for sufficiently granular data to record all transactions and measure the contribution of individual transactions to the overall exposure.

In addition, firms should integrate their IRRBB strategy into their overall strategic objectives and risk appetite.

How will the changes impact firms?

The updated guidelines substantially increase the rigour required in IRRBB modelling and model governance by introducing a broad set of rules requiring adjustments to most firms' ICAAP processes.

The EBA expects firms to identify their existing and prospective exposure to IRRBB in a proportionate manner, depending on the level, complexity and riskiness of their banking book positions. Despite this expectation, the step up from the 2015 to the latest guidelines may require significant development in most firms' IRRBB frameworks, requiring them to reconsider all aspects of their end to end IRRBB processes, including governance, measurement and modelling.

The EBA's requirement of incorporating the IRRBB model risk into ICAAP may be new to many firms. Further, model validation requirements may constitute a significant change for treasury and asset and liability management (ALM) functions that may not have had their models validated before. Any firms that have not already done this will have to act now.

Firms can use the updated guidelines as an opportunity to further integrate IRRBB activities into their broader risk and planning frameworks. By leveraging their processes, they can capture the synergies between different modelling approaches to achieve a more robust risk and capital management framework.

While implementing the updated standards, firms should retain the flexibility to implement further technical standards from the EBA, which are expected following the finalisation of CRD V / CRR2 framework. In particular, they should keep their IRRBB change programs live and plan for additional workload in their key Treasury, Risk, and IT functions over the next couple of years.

Many institutions will have begun upgrading their IRRBB management following the 2016 Basel Standards and we expect the difficulty for firms in implementing these guidelines to depend, in large part, on the degree to which they have already implemented these standards, as well as on the rigour of their existing IRRBB process.

Next steps

The EBA pushed back the implementation of the guidelines from 31 December 2018 to 30 June 2019, with transitional arrangements for specific provisions until 31 December 2019. These guidelines are intended to act as a transition to the forthcoming CRD V / CRR2 framework, after which the EBA plans to publish more detailed technical standards on IRRBB.

Some elements of the BCBS Standards, such as the Pillar 3 disclosure requirements or the standardised methodology are not included in the final EBA guidelines. We expect the EBA to publish further technical details including these points following the finalisation of the CRD V / CRR 2 framework. We would further expect these technical standards to add quantitative detail to the points covered in the current guidelines.

Given the EBA's overhaul of its IRRBB guidelines, we expect the PRA to update its current *Pillar 2 Capital guidelines* which sets out the methodologies that it uses to determine the capital add-ons for IRRBB by publishing a new Statement of Policy. But, considering the ongoing CRD 5 / CRR2 and Brexit negotiations, it is possible that this will be delayed until after these negotiations are over.

What do firms need to do?

- Firms should familiarise themselves with the revised IRRBB guidelines and begin assessing the impact of the new guidelines on their Pillar 2 capital assessment processes, and their wider IRRBB management frameworks.
- Firms should ensure their IRRBB strategies are aligned with their organisational strategic objectives and risk appetites.
- Firms will need to enhance their governance processes across all levels of IRRBB management, including board level oversight.
- Firms will have to ensure that sufficient resources are available in ALM, Risk and IT to comply with the enhanced requirements on these functions.
- Firms will have to increase the rigour of their IRRBB modelling and model governance processes due to the increased focus on IRRBB model risk, which will now be included within the ICAAP.
- Firms should integrate supervisory outlier tests into their overall IRRBB processes and avoid breaching the new threshold which would trigger increased supervisory scrutiny.
- Firms should look for opportunities to use the improvements made for IRRBB in other areas, while retaining the flexibility to implement further technical standards from the EBA.

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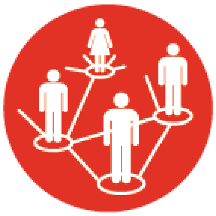

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