

EBA'S NEW REQUIREMENTS ON CSRBB MANAGEMENT

A whitepaper by Advantage Reply

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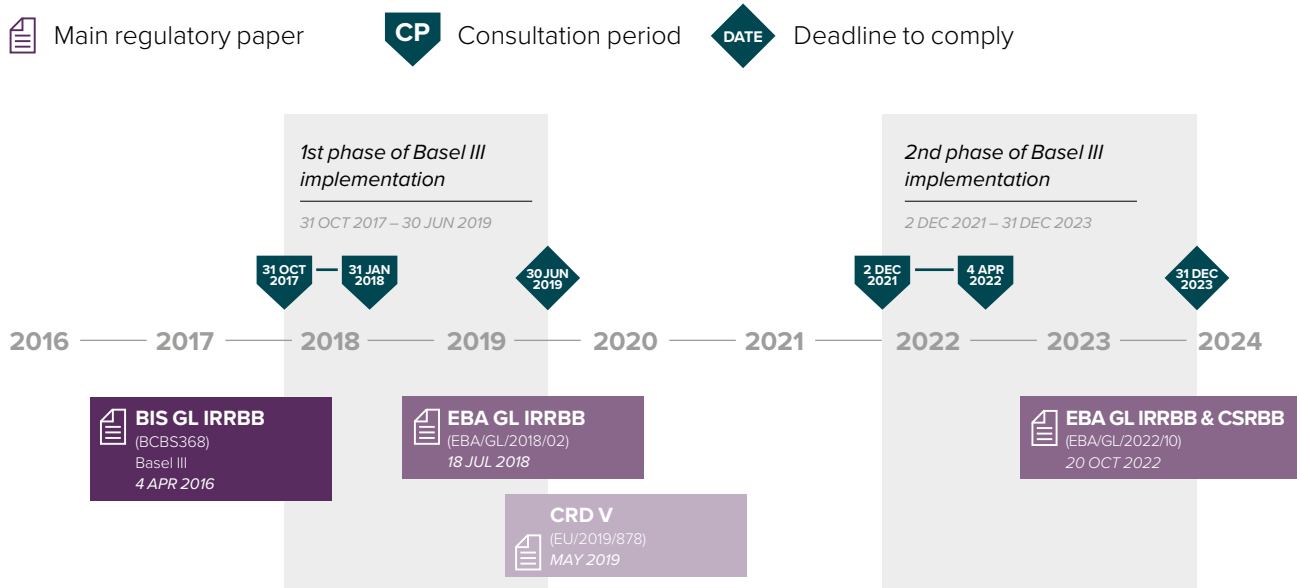
CONTEXT

On 20 October 2022, the European Banking Authority (EBA) published new regulatory requirements on Interest Rate Risk and Credit Spread Risk in the Banking Book (IRRBB / CSRBB) aiming to finalise the implementation of Basel III requirements (BCBS368, Guidelines on IRRBB) in the European Union.

THIS SET OF REGULATORY REQUIREMENTS IS COMPOSED OF 3 PAPERS:

1. The Guidelines on IRRBB and CSRBB (EBA/GL/2022/14), replacing current guidelines published in 2018;
2. The final draft Regulatory Technical Standards (RTS) on the IRRBB standardised approach (EBA/GL/2022/09); and
3. The final draft RTS on IRRBB supervisory outlier tests (EBA/GL/2022/10).

IMPLEMENTATION IN EU OF BASEL III REQUIREMENTS ON CSRBB MANAGEMENT



CONTEXT (CONT.)

These publications follow the consultation period that started in December 2021 and aim to reply to several mandates given through the Capital Requirements Directive (CRD V) to the EBA.

THESE PAPERS ARE CONSIDERED TO BE CRUCIAL BY THE EBA, ESPECIALLY IN THE CURRENT EVOLVING INTEREST RATES ENVIRONMENT AND INCLUDE NEW DEVELOPMENTS ON:

- Assessing and monitoring CSRBB as mandated by the article 84 (6c) of the CRD V;
- Identifying non-satisfactory internal models of IRRBB management as mandated by the article 84 (6d) of the CRD V;
- Repricing maturity of non-maturing deposits with the implementation of a 5-year weighted average cap;

The standardised and simplified standardised approach for IRRBB management as mandated by the article 84 (5) of the CRD V; and

- Specifying modelling and parametric assumptions of the SOT and defining the SOT on the net interest income as mandated by the article 98 (5a) of the CRD V.

This note focuses on the implications for CSRBB management of the final Guidelines published in Oct-2022.

DEFINITION

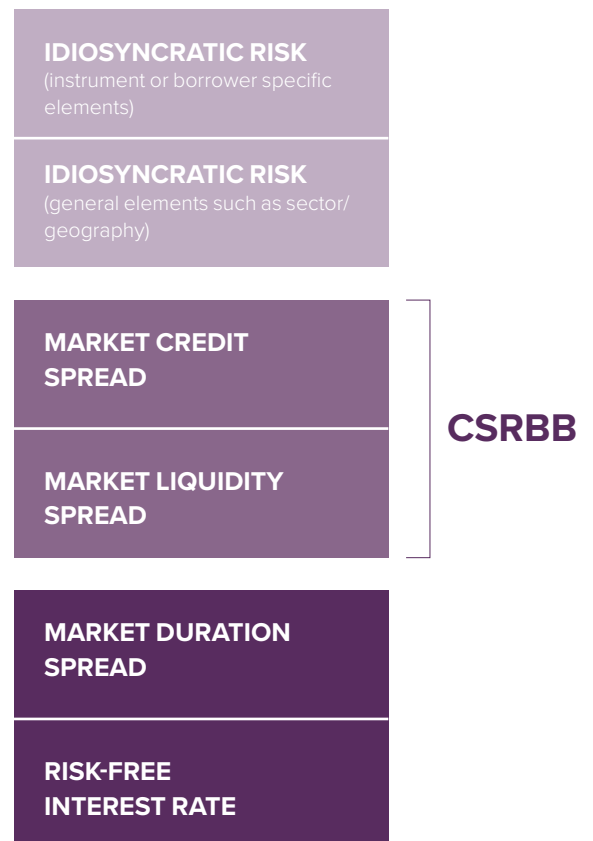
The CSRBB is still defined as the risk driven by changes of the market price for credit risk, for liquidity and for potentially other characteristics of credit-risky instruments. This risk excludes the part captured by another existing prudential framework such as IRRBB or by expected credit/(jump-to-) default risk. Thus, the CSRBB captures the risk of an instrument's changing spread while assuming the same level of creditworthiness.

Regarding the difficulty to identify the different elements of client rates, the EBA does not suggest separating the assessment of market-credit and market-liquidity spreads.

Despite the fact that CSRBB definition excludes idiosyncratic risk (due to the credit quality of the individual borrower and the specifics of the credit instrument), in order to avoid an overlap with the credit risk framework, the EBA authorises their inclusion for practical and proportionality reasons as long as it is ensured that the measures will yield more conservative results (art. 157).

- For certain non-marketable instruments, the identification of CSRBB component in the client rate may lead to a complicated overlap with IRRBB measures (inclusion of commercial margins and other spread components in NII and potentially EVE measures, unclear correlation between client rate and risk-free interest rate, etc.).
- Moreover, identification of the idiosyncratic risk could be very complex for instruments on which interest rate is linked to funding rate or administered rate (retail loan, deposits). Finally, the practical use of the idiosyncratic risk inclusion seems tricky due to the obligation to ensure a more conservative result.

CLIENT RATE BREAKDOWN

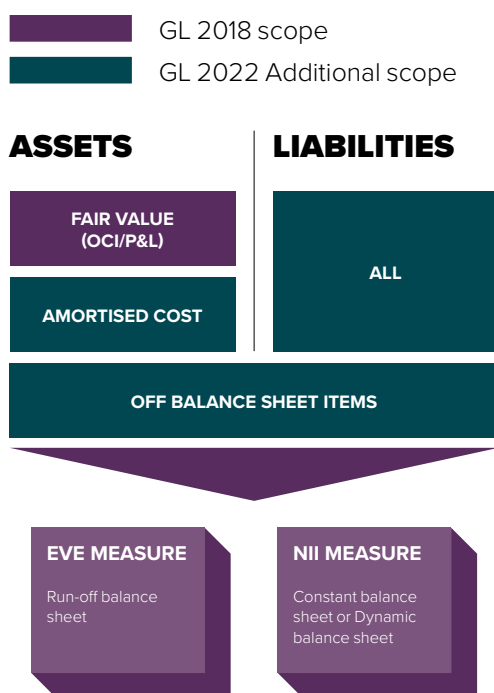


Source: EBA Guidelines on IRRBB & CSRBB (EBA/GL/2022/14)

SCOPE

The CSRBB scope was possibly the most discussed topic during the consultation period.

CSRBB SCOPE OF APPLICATION



Source: *Avantage Reply*

Although the final guidelines merely do not change from the consultation version, several clarifications are highlighted in the feedback section of the final report. In the new guidelines published in 2022, the EBA increases the perimeter of CSRBB by ruling out that no instrument should be excluded ex-ante, irrespective of their accounting treatment. Any exclusion should be documented and justified. Assets accounted at fair value should not be excluded in any case.

It is important to note that important detail on scope is located in the Feedback section of the Guidelines.

- The Basel committee explained in the Guidelines on IRRBB that CSRBB was only identifiable on marketable instrument accounted at fair value, leading to the conclusion that spread components of amortised cost instruments should be integrated within the IRRBB framework.
- The different versions of the EBA Guidelines on the SREP provide a definition of Credit Spread Risk as the risk arising from changes in the market value of debt financial instruments due to fluctuation in their credit spread.

- In the 2018 Guidelines on IRRBBB, the EBA stated that CSRBB should only be calculated on the asset side of the non-trading book (Art. 18).

BY COMBINING THESE TWO DEFINITIONS, MOST FINANCIAL INSTITUTIONS UNTIL NOW HAVE ONLY ASSESS CSRBB ON FAIR-VALUED MARKETABLE ASSETS.

IDENTIFICATION, ASSESSMENT & MONITORING

Overall, the requirements on governance, strategy, risk assessment, policies process and controls are broadly close to those on IRRBB, the main difference being that CSRBB is not a hedgeable risk, excluding part on derivatives or some elements on model governance.

The Guidelines requires the implementation of internal control mechanisms, based on the risk appetite of the institution. However in contrary to IRRBB management chapters, the Guidelines do not establish any specific quantitative limit or capital requirements derived from it.

Finally, financial institutions should use economic value measures and net interest incomes measures (new production) plus market value changes. There is however very limited guidance with regards to the measurement of CSRBB in those two perspectives,

in particular on the type of shocks to consider. Accordingly, there remains significant uncertainty regarding the expected level of granularity (sectors, geographies, ratings, maturities, ...) in their definition, the calibration method and time horizon.

Then institutions should review the risk taxonomy and quantify the risk with those new requirements in order to decide to include specific changes in their stress-tests and ICAAP process.

CONCLUSION

With the publication of updated guidelines, the EBA increases regulatory scrutiny of CSRBB.

Even if an important part of requirements is similar to those on IRRBB, the EBA leaves room for institutions to develop their own risk management framework. But by not being prescriptive and avoiding detailed examples as asked by several participants during the consultation period, the EBA takes the risk of a very heterogeneous implementation.

Finally, even though the implementation date for CSRBB requirements have been delayed 6 months after the other requirements of those 3 regulatory papers, an application at the end 2023 seems quite challenging for institutions to tackle.

HOW CAN WE HELP YOU?

Please feel free to contact us if you have any questions about this publication or wish to discuss the effects of the new requirements. Advantage Reply can help with the global implementation of an IRRBB or CSRBB management strategy including:

1

FRAMEWORK

Institution-specific gap analysis, risk framework benchmarking, design a new compliant CSRBB management framework

2

SCOPE

Review of institution-specific potential scope within the EVE and NII approaches of CSRBB and breakdown by relevant dimensions

3

SCENARIOS

Create scenarios for usual management or stress-tests purposes

4

METRICS & CALCULATION

Define and calculate relevant metrics (EVE/NII).

ABOUT AVANTAGE REPLY

Avantage Reply (a member of the Reply Group) is a pan-European specialised management consultancy delivering change initiatives in Risk, Compliance, Finance (Capital Management and Regulatory Reporting), Treasury and Operations within the Financial Services industry.

WITHIN OUR CORE COMPETENCIES, WE HAVE EXTENSIVE EXPERIENCE IN IMPLEMENTING CHANGES DRIVEN BY:

- Industry-wide legislative and regulatory initiatives (e.g. CRD, BRRD);
- Mergers, Acquisitions & Divestments (e.g. business combination, separation and flotation); and
- Business improvement and optimisation agendas (e.g. risk appetite and capital allocation).

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