



# EBA IRRBB Guideline

## EBA/GL/2018/02 on the Management of Interest Rate Risks in the Banking Book

July 2018

### Continuous focus on interest rate risk: EBA finalizes IRRBB Guideline

#### Summary

On 19 July 2018, the European Banking Authority (EBA) published the new Guideline on the Management of Interest Rate Risks in the Banking Book (IRRBB)<sup>1</sup>. In mid-2019, the new guidelines will replace the previous EBA IRRBB Guideline published in 2015. Starting on 30 June 2019, the new Guideline will apply to all financial institutions and regulators in the European Union. By means of the new guideline, the EBA implements the Basel paper BCBS 368 requirements regarding banks' internal IRRBB management and the regulatory outlier test in Europe.

In the context of the regulatory roadmap, the paper – in conjunction with the EBA guidelines on SREP<sup>2</sup> and stress testing<sup>3</sup> – strengthens the Pillar 2 approach. Hereby, we observe a further alignment of these Guidelines. For instance, the consideration of the normative perspective of the ICAAP as well as of an integrated strategic planning process shows the alignment with the SREP and stress test guidelines. Overall, the guidelines provide a consistent view on the requirements regarding monitoring and managing IRRBB. This is also reflected in the audit instructions of competent authorities.

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► Link to EBA Guideline 2018/02:  
<http://www.eba.europa.eu/documents/10180/2282655/Guidelines+on+the+management+of+interest+rate+risk+arising+from+non-trading+activities+%28EBA-GL-2018-02%29.pdf>

<sup>1</sup> EBA/GL/2018/02

<sup>2</sup> EBA/GL/2018/03

<sup>3</sup> EBA/GL/2018/04

## Changes to the Guideline

The final Guideline discussed here includes only small changes compared to the consultation paper. Through the finalization as well as some clarifications, the Guidelines now provide clarity on requirements.

Compared to the IRRBB Guideline from 2015<sup>4</sup>, which is still in place, the new Guideline still contains all relevant components. However, further requirements have been included, in particular regarding consistency between accounting, planning and risk, as well as regarding the validation of IRRBB models.

Below, we present some relevant extensions compared to the previous EBA IRRBB Guideline.

## Accounting, Planning and Internal Risk Perspective

Often, the requirements of the previous Guideline – regarding both the present value view and the periodic view – have been interpreted particularly from an economic perspective. The new Guideline, however, outlines that accounting aspects shall be considered comprehensively. In order to meet the requirements, banks need to measure the impact of interest rate shifts on all balance sheet and P&L positions.

Consequently, in future, the impact of interest rate shifts on Other Comprehensive Income (OCI) as well as impacts from Hedge Accounting need to be considered in risk management. In particular for the definition of the risk appetite, tolerable volatilities of P&L and equity (from an Accounting perspective) need to be taken into account. Across German banks, such a broad definition of IRRBB and risk appetite is not yet a common approach.

The extension of requirements by accounting aspects is in line with the normative ICAAP. In this context, consistency between planning and the simulation of new business is an important and complex requirement.

## Model Validation

In the new Guideline, the EBA recognizes the importance of models regarding IRRBB. In particular, the required scope of independent model validations has been extended and specified. This includes initial validations before implementation of new models as well as ongoing validations and benchmark assessments. Such assessments require the introduction of alternative modes, so called “Benchmark Models”. These models allow for a review of adequacy of models and for an identification of inherent model risks.

In the context of Benchmark Models, the IRRBB standard model proposed by the BCBS may be of importance. The implementation of this model would enable banks to obtain a regulatory perspective on their risk.

Numerous European banks are currently setting up independent model validation. In the context of IRRBB, these models usually

<sup>4</sup> EBA/GL/2015/08

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focus on model parametrization. Initial validations, adequacy assessments as well as benchmark analyses are not yet market standard.

Due to the extended requirements, validation functions need to increase efforts and the degree of specialization.

### Credit Spread Risk in the Banking Book

Regarding the related topic of Credit Spread Risk in the Banking Book (CSRBB), the EBA defines general requirements on monitoring and steering – as long as CSRBB is a material risk on the asset side of the bank. The EBA has now clarified that it refers to spread risks on the asset side, which arise due to changes to the general market valuation.

The EBA does not limit the application based on accounting categories. Consequently, it is necessary to check if non-consideration of CSRBB is justified for instruments that are intended to be held until maturity. In particular for the present value perspective, we have a critical view on the practice of some banks.

Regarding CSRBB requirements, an additional transition period of six months applies for small and less complex institutions (SREP category 3 and 4). The CSRBB requirements of the new Guideline are, in contrast to the rest of the Guideline and in line with the consultation paper, not very specific. It is however expected that the EBA will publish a separate CSRBB Guideline on the basis of CRD V requirements.

### Regulatory Interest Rate Shock and Outlier test

The EBA has specified its requirements regarding the regulatory outlier test. This is of particular relevance for German banks, as BaFin has recently published Circular 9/2018 regarding the national outlier test.

As before, banks need to calculate the present value effect of a 200 bp interest rate shock on the banking book based on risk-free discount curves. However, a new requirement is the obligatory application of the six BCBS scenarios. In this context, the maximum loss under all scenarios in relation to the core capital (CET1) is the key metric. It is now required for this metric to consider a warning level of 15% in addition to the previous outlier criterion of 20%.

In line with the BCBS paper, the Guideline includes the possibility to exclude margins from the assessments. This approach has already been described in BaFin Circular 9/2018.

For the negative scenario, the Guideline defines a linear interest rate floor between -100 bp for the short term and 0 bp for tenors above 20 years. In the consultation paper, the interest rate floor for the short term was -150 bp, and the EBA explicitly retains the possibility of further adjustments to this market interest rate floor.

In contrast to current requirements of German regulators and in contrast to the consultation paper, the calculation of the aggregated EVE effect needs to consider not only negative, but also positive changes separately in all relevant currencies. Hereby, a factor of 50% shall be applied by currency for positive changes.

The BaFin is now required to consider the new EBA requirements in a new Circular. In turn, the EBA is required to align its reporting requirements in the context of the Short Term Exercise accordingly by 30 June 2019.

### Recommendations

In 2018, IRRBB is once again a topic of high priority for regulators. Through the new Guideline, the EBA is tightening its formal requirements. Additionally, the ECB and the German authority have intensified their activities to ensure that those requirements are met.

Consequently, banks should also give high priority to an adequate monitoring and steering of IRRBB and, where necessary, review the entire framework. We recommend analyzing how to deal with new requirements and clarifications. The timeline for implementation until mid-2019 is quite short.

German banks are currently focusing on the measurement of a periodic, P&L-oriented perspective. While many banks have not finalized such projects, the new Guideline already includes new requirements, such as the integration of accounting aspects. Banks should assess whether the new requirements can be integrated into current projects. In a first step, we recommend assessing both the expected periodic interest income

and the change to the present value of positions subject to Fair Value Accounting for relevant interest rate scenarios (if this has not yet already been done).

Additionally, banks should – also in the context of extended requirements regarding consistency between planning and risk measurement – aim at further integrating functions. The current EBA stress test shows that risk and finance functions must work closely together in order to cope with this task.

Significant negative market interest rates are now reflected in regulatory scenarios. Banks that still apply zero floors on market interest rates should assess the impact of more negative interest rates.

Regarding CSRBB, the EBA has defined its fundamental (yet not very detailed) expectations and requires implementation by 2019. Current market practice shows heterogeneous treatment of CSRBB. Particularly in anticipation of the expected, separate CSRBB guidelines, our recommendation for all banks is to assess their approach and to identify and close relevant gaps in a timely manner.

Finally, in our view, only a few German banks meet the EBA requirements on IRRBB model governance and validation. We therefore recommend developing a model validation approach across all risk types, taking in particular the requirements regarding IRRBB models into account.

### Next Steps and Outlook

The EBA GL will become applicable already on 30 June 2019. As observed in the context of the previous guideline, regulators will insist on fulfillment of the respective requirements. Our recommendation to banks is therefore to address the above topics timely and prepare for upcoming challenges.

Regulators have officially clarified that interest rate risk has a high priority in their oversight activities in 2018. Accordingly, we are currently observing a high number of On-site Inspections and numerous requirements of Joint Supervisory Teams regarding IRRBB at large banks, as well as an increased number of German KWG Section 44 audits at smaller banks. Through further implementation of CRR2/CRD5, additional publications regarding reporting requirements and the IRRBB standard approach will increase the pressure on banks.

**Feel free to contact us!**

Our team of experienced experts in Trading & Treasury, Regulatory & Business Technology are happy to support you in optimally preparing for requirements facing the internal management of Interest Rate Risks in the Banking Book!

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