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European Banking Industry Common Understanding of Credit Spread Risk in the Banking Book (CSRBB) defined by the European Banking Authority (EBA) Guidelines on the Management of Interest Rate Risk Arising from non-Trading Book Activities

Context

In April 2016, the Basel Committee on Banking Supervision (*BCBS*) published the *Standards on Interest Rate Risk in the Banking Book*[1] (*IRRBB*).

The forthcoming Capital Requirements Directive (*CRD 5*) and Capital Requirements Regulation (*CRR 2*) factor the *BCBS Standards* in the European Union (*EU*) regulatory framework. The final text of the so-called *Risk Reduction Measures* (*RRM*) package including *CRD 5* / *CRR 2* was adopted by the European Parliament in mid-April 2019. The *CRD 5* / *CRR 2* will be published in the Official Journal of the European Union in May / June 2019 and enter into force shortly thereafter. The new *IRRBB* framework outlined in *CRD 5* (in *CRR 2* with respect to *IRRBB* public disclosure) shall apply two years after the date of entry into force. *CRD 5* mandates the European Banking Authority (*EBA*) to complement the directive by drafting Regulatory Technical Standards (*RTS*) to submit to the European Commission or by issuing guidelines within one year after the publication.

Well ahead of the application of *CRD 5* / *CRR 2*, the *EBA* elected to publish, on the 19th July 2018, *Guidelines on the Management of Interest Rate Risk Arising from non-Trading Book Activities*[2] (‘*EBA Guidelines*’), anticipating the introduction of some elements of the *BCBS* standards, with first application date on the 30th June 2019. The industry considered this debatable, notably for the changes to the Supervisory Outlier Test (*SOT*) and the early introduction of measures on Credit Spread Risk in the Banking Book (*CSRBB*), for which *CRD 5* gives a specific mandate to *EBA*[3].

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[1] https://www.bis.org/bcbs/publ/d368.pdf
[2] EBA/GL/2018/02.
[3] Article 84, paragraph 5 of the *CRD 5* tasks *EBA* to develop, by one year after *CRD 5* entry into force, guidelines on ‘*the criteria for the assessment and monitoring by institutions of the risks referred to in paragraph 2*’ whereby paragraph 2 is ‘*Competent authorities shall ensure that institutions implement systems to assess and monitor the risks arising from potential changes in credit spreads that affect both the economic value of equity and the net interest income of an institution's non-trading book activities.*’.

EBA presents this front running process "*in order to bridge the timing gaps and ensure consistency between*" the current and future applicable regulatory framework.

Indeed, the *EBA Guidelines* do not provide enough clarity on how banks are expected to approach the *CSRBB* issue. A review of the *EBA Guidelines* in that respect is not envisaged in the short term and, considering the number of mandates *CRD 5* / *CRR 2* tasks *EBA* with, the industry is concerned that *EBA* might not be able to meet the *CRD 5* deadlines.

In this context, the European banking industry, through the European Banking Federation (*EBF*) *IRRBB* Working Group ('*EBF IRRBB WG*'), decided to articulate this memorandum which specifies the "***European Banking Industry Common Understanding of CSRBB as defined by EBA Guidelines***".

European Banking Industry Common Understanding of CSRBB as defined by EBA Guidelines

The European Banking Industry common understanding of *CSRBB* as defined by *EBA* Guidelines is that it relates to Banking Book assets (*"CSRBB-assets")*:

- **that are actively traded on a deep and large market**;
- **that are held in a *business-model* envisaging a possible sale before maturity in a *business-as-usual* environment;**
- **which market value is affected by the *Credit Spread*-risk component.**

whereby:

  - ***business-as-usual*** refers to the course of normal business activities, i.e. the bank is not affected by extraordinary events[4].
  - ***Credit Spread-risk* component** is defined as changes in the market value which are not explained by interest rate risk or by '*expected credit / (jump to-) default risk*'.

Considering the definition of *CSRBB* outlined in the *EBA* Guidelines, **the metric to monitor and assess *CSRBB* is**:

- **the sensitivity of the market value of *CSRBB-assets* to changes in the *Credit Spread-risk* component**
- avoiding double counting with credit / (jump to-) default risk.

Institutions should articulate the degree of sophistication of the monitoring according to the principle of proportionality, based on the size and complexity of the institution and on its exposure to *CSRBB*.

[4] E.g. stress test-circumstances such as liquidity stress test, recovery mode or resolution mode) which would lead the bank to change its management intention significantly and could lead to sell those assets in extraordinary circumstances relating to other sources of risk (e.g. liquidity contingency plan, recovery plan).

Illustration

Market tradable assets in the Banking Book[5] may be held i) in a *buy-and-hold* business model, i.e. with the intent to hold these assets to their maturity, or ii) in an *available-for-sale* business model, i.e. with the intent to potentially sell these assets before maturity, depending on market conditions.

The accounting treatment of these assets is usually derived from the *business-model* in which they are held. This is illustrated in this note by reference to the International Financial Reporting Standards (*IFRS9*) below and in particular:

- *Held-to-Collect–and-Sell Assets* (*HtC&S*) refer to assets having the management intention to both collect the contractual cash flows and sell the financial asset before maturity. *HtC&S* assets are accounted for at fair value, and changes in market values are recognized through *Other Comprehensive Income* (*OCI*), as these changes may affect future *Profit and Loss* (*P&L*) before the maturity of these assets.

- *Held-for-Trading Assets* (*HfT*). There might be circumstances in which market tradable assets, though held with the management intent to sell them in the short term horizon, are nevertheless classified in the Regulatory Banking Book. *HfT* assets are accounted for at their fair value, and changes in the market value of *HfT* items are recognized directly through *Profit and Loss* (*P&L*).

- *Held-to-Collect Assets* (*HtC*) refer to assets expected to be held to their maturity by collecting contractual cash flows. Consequently, *HtC* assets are accounted for at amortizing cost and not at fair value[6], and changes in the market value of these assets do not affect P&L or *OCI*.

The *CSRBB-assets* would cover banking book market tradable assets accounted for:

- *HtC&S* assets, *as expected to be possibly sold before maturity,* and
- *HfT assets, included in the prudential Banking Book, as expected to be sold in a short term horizon*.

Accordingly, items accounted for at amortised are not considered *CSRBB assets*.

On these *CSRBB-assets*, the impact of *CSRBB* could be monitored and assessed by calculating the changes in fair value considering shocks applied to asset swap spreads, to filter the *IRRBB*-component and assuming no changes in '*expected credit / (jump to-) default risk*'.

[5] Usually, a bank owns market tradable assets in the Banking Book to maintain a liquidity buffer (notably to comply with internal liquidity stress tests or with the Liquidity Coverage Ratio, *LCR*, regulatory requirement).

[6] HtC items are customarily accounted for at amortised cost, including possible impairment, that relates to the '*expected credit / (jump to-)default risk*' that *EBA* filters out of *CSRBB*. Banking Book Assets having a held-to-collect business model but not meeting certain requirements (so called Simple Payment of Principal and Interest-*SPPI* test) are accounted for at fair value through *P&L*. However, the business model does not change as the management intention is to collect the contractual cash flows until their maturity.

Detailed Analysis of the EBA Guidelines

Definition of CSRBB

The *EBA Guidelines* definition of CSRBB is (cf. p14):

Credit spread risk from non-trading book activities (CSRBB)	The risk driven by changes in the market perception about the price of credit risk, liquidity premium and potentially other components of credit-risky instruments inducing fluctuations in the price of credit risk, liquidity premium and other potential components, which is not explained by IRRBB or by expected credit/(jump-to-)default risk.

Paragraph §18 of the Guidelines (cf. p.17) further details the scope as covering only assets:

18. Institutions should monitor and assess their CSRBB-affected exposures, by reference to the asset side of the non-trading book, where CSRBB is relevant for the risk profile of the institution.

Considering this definition and the scope of application in detail, it is clear that *CSRBB* targets the *market perception* inducing *fluctuations in the market price of asset instruments*. Hence, ***CSRBB* relates to market tradable assets of the *Banking Book***. Indeed, from the initial part of the definition, only instruments that have a clear *market price* transparency are considered, i.e. easily tradable on a large and deep enough market, since only such market tradable assets are subject to such a *market perception*.

Then the issue is to identify how risk is affected by changes in the price of these market tradable assets.

Since the risk of losses might materialise only in case of a sale of the involved assets, it is common understanding that assets held under a business model not envisaging their sale are excluded from the scope of the CSRBB assessment.

Under *IFRS9*, tradable/marketable assets that are *Held-to-Collect* (*HtC*) are unaffected by a change in their price since they are held in the intent to be held to their maturity, and hence are unaffected by the temporary changes in their market price.

Changes in prices of tradable assets that are *Held-to-Collect-and-Sell* (*HtC&S*) may lead to a risk only if they are sold at prevailing market prices. Hence, the risk is *conditional* to assuming a sale of these tradable assets.

Market tradable assets that are *Held-for-Trading* (*HfT*) in the regulatory Banking Book, though expected to be limited in circumstances, would be almost directly affected by changes in their prices through the *Profit-and-Loss* (*P&L*) statement, because the economic risk would materialise in the short term (due to the inherent business model).

Under IFRS9, the *CSRBB-assets* would therefore cover banking book market tradable assets classified as:

- *HtC&S as they are expected to be possibly sold before maturity,* and
- *HfT, in the prudential Banking Book, as they are expected to be sold on a short term horizon*.

Accordingly, items accounted for at amortised cost are not considered *CSRBB assets*.

Please note that this scope of application of *CSRBB* is consistent with the Basel Committee on Banking Supervision's (*BCBS*) Standards on Interest Rate Risk in the Banking Book (*IRRBB*) of April 2016 as described in the Appendix.

It is also worth mentioning that the *EBA Guidelines on Supervisory Review and Evaluation Process* (*SREP*)[7] address the credit spread risk arising from non-Trading Book positions as well. Paragraph 310, at the beginning of the *IRRBB* section, references the market risk section ("*note that credit spread risk arising from some non-trading book positions is covered in the section on market risk*"). In this section, paragraph 221 point a. states that banks should assess, in relation to the Banking Book, "*credit spread risk arising from positions measured at fair value*". Therefore, also according to the *EBA* Guidelines on *SREP*, items accounted for at amortised cost are left out of the scope of the *CSRBB* assessment.

In any case, according to the principle of proportionality, *CSRBB* assessment and monitoring should only be required where the positions involved are material and relevant for the risk profile of the institution.

In addition, the EBF understands from the *CSRBB* definition that, in order to avoid double counting with other regulatory requirements, *CSRBB* excludes *IRRBB* and credit risk covered by expected credit/jump to default. The exclusion of credit/ jump to default proves to be challenging, and this is still being discussed and considered.

<u>Monitoring Process</u>

As per §18 of the *EBA Guidelines*, *CSRBB* should be monitored and assessed.

The monitoring process is basically a regular assessment of *CSRBB* adapted to its materiality (i.e. *CSRBB* monitoring process should be stronger when deemed material).

The following was provided within the *Background and rationale* section of the *EBA Guidelines*:

12. While the current guidelines explicitly state that they do not apply to credit spread risk from non-trading book activities (CSRBB), the scope of these updated guidelines has been expanded, thus also covering CSRBB in line with the BCBS Standards. The updated guidelines provide a definition of CSRBB and a high-level expectation for institutions to identify their CSRBB exposures and ensure that CSRBB is adequately monitored and assessed.

[7] EBA/GL/2014/13 - consolidated version after July 2018 update.

It should be noted that *EBA*'s position has evolved from the original *EBA* consultation paper and this is clear from the comments provided by EBA on page 78 of the Guidelines:

The EBA agrees that the guidance included in the guidelines on CSRBB is high level. In this respect, we amended the wording to fully align it with the requirement on CSRBB in the BCBS Standards. In line with the transitional and progressive approach to the implementation of the BCBS Standards, CSRBB has been included in the scope of the guidelines to allow banks to prepare for its implementation. More detailed requirements will be included in the guidelines expected to be issued under the mandate of CRD V.	The guidance on CSRBB in paragraph 18 has been amended as follows: Institutions should ~~identify~~ monitor ~~measure~~ and assess their CSRBB-**affected** exposures, **by reference to the asset side of the non-trading book**, ~~and ensure that CSRBB is adequately controlled if~~ where CSRBB is relevant for the risk profile of the institution.

Assessment Framework

The *EBA Guidelines* do *not* articulate how *CSRBB* should be monitored and assessed.

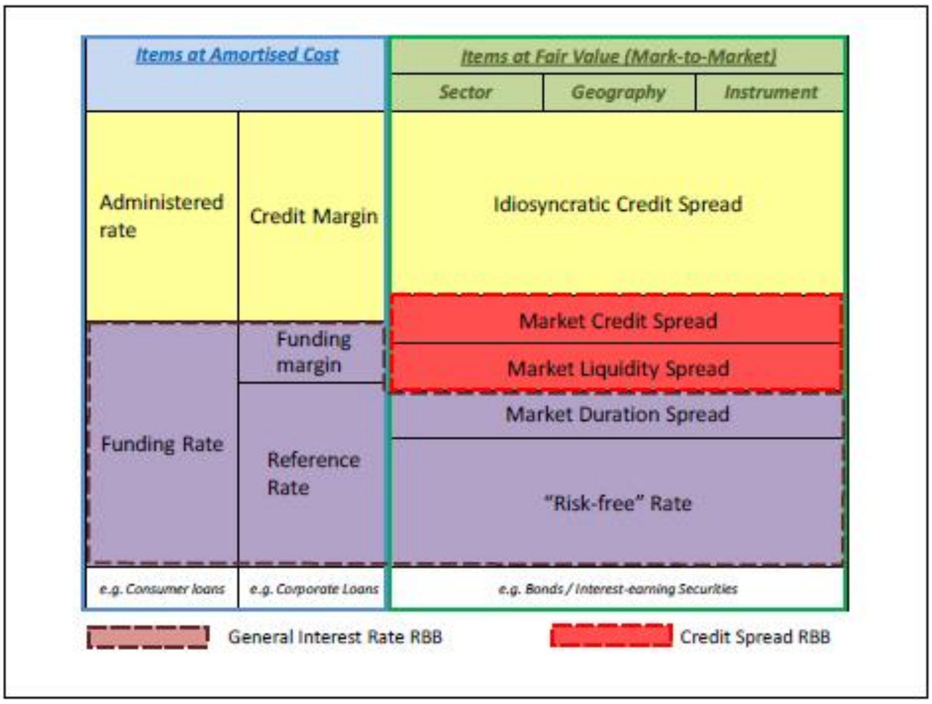
Considering the nature of the *CSRBB,* it is pertinent to monitor it through the sensitivity of the price (economic value) of market tradable assets in the Banking Book to market components that relate *neither* to *IRRBB* nor to the *expected credit/jump-to default* risks. This typically could take the form of price sensitivity to a change in market credit spread that does not relate to *IRRBB* (e.g. sensitivity to asset swap spread).

Banks should develop their own methodology and metrics for assessing and monitoring *CSRBB*. In any case, the principle of proportionality should be applied. Approaches based on full revaluation should not be mandatory and simpler methodologies should be considered suitable, as well as very simplified tools for smaller banks.

Appendix –*BCBS* Standards – *CSRBB* References

Changes to the *risk-free rate, market duration spread, reference rate and funding margin* all fall within the definition of IRRBB. C*hanges to the market liquidity spreads and market credit spreads* are combined within the definition of CSRBB. The diagram below gives a visual representation of how the various elements fit together.

Figure 1 – Components of interest rates



1.4 IRRBB and CSRBB

The main driver of IRRBB is a change in market interest rates, both current and expected, as expressed by changes to the shape, slope and level of a range of different yield curves that incorporate some or all of the components of interest rates.

When the level or shape of a yield curve for a given interest rate basis changes, the relationship between interest rates of different maturities of the same index or market, and relative to other yield curves for different instruments, is affected. This may result in changes to a bank's income or underlying economic value.

CSRBB is driven by changes in market perception about the credit quality of groups of different credit-risky instruments, either because of changes to expected default levels or because of changes to market liquidity. Changes to underlying credit quality perceptions can amplify the risks already arising from yield curve risk. CSRBB is therefore defined as any kind of asset/liability spread risk of credit-risky instruments which is not explained by IRRBB, nor by the expected credit/jump-to-default risk.

This document focuses mainly on IRRBB. CSRBB is a related risk that needs to be monitored and assessed.

About EBF

The European Banking Federation is the voice of the European banking sector, uniting 32 national banking associations in Europe that together represent some 4,500 banks - large and small, wholesale and retail, local and international - employing about 2.1 million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that securely handle more than 300 million payment transactions per day. Launched in 1960, the EBF is committed to creating a single market for financial services in the European Union and to supporting policies that foster economic growth.

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