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Considerations for the local implementation of IRRBB (BCBS-d368)

After focusing their attention on implementing liquidity related regulation, many regulators across the globe are now pursuing the implementation of IRRBB guidelines. With a BCBS deadline of Dec.2018, the latest BCBS progress report (April 2018, BCBS d440), shows that several of the member countries, are in the process of drafting related guidelines (status=1), have put out a draft for public consultation (2), have published the final rule which is yet to be implemented (3), and only a few have the final rule in force (4). Many other non-member countries are also in the consultation / implementation process, either as a stand-alone rule or as part of a wider market risk management regulation. In drafting and negotiating IRRBB guidelines, what are some of the relevant points, options and implications that both regulators and banks should consider?

IRRBB implementation status*
Mar-18

Country	Status
Argentina	3
Australia	1
Brazil	3
Canada	1
China	2
Hong Kong SAR	2
India	2
Indonesia	2
Japan	4
Korea	1

Country	Status
Mexico	1
Russia	1
South Arabia	4
Singapore	2
South Africa	1
Switzerland	2
Turkey	1
United States	2
European Union	2

** Source: BCBS 14th Progress report on adoption of the Basel regulatory framework (Apr. 2018)*

- **How to adjust to local conditions:** BCBS implemented a Pillar 2 approach due to the complexities involved in formulating a standardised measure of IRRBB which would be both sufficiently accurate and risk-sensitive to establish capital requirements. It is now up to the local regulators to evaluate and if deemed necessary adjust BCBS guidelines to local conditions. Should individual non-member countries adopt the BCBS six prescribed scenarios? How to adjust for specific market characteristics?

  For example, in the case of the UK and Canadian banking system, while amortizing over long periods (20+ years) mortgages are not long term fixed rate, with contractual rate terms usually below 5 years. The parameters used to calculate the BCBS interest rate shock scenarios for some developed currencies make the two parallel scenarios the only relevant ones around the 5-year term, with the other scenarios falling in the 0 to +100 bp range (see next graph).

  What other market specific considerations should be addresses using specific guidance (e.g. Federal Reserve guidance on rate sensitive deposits, EBA exclusion of NMD from F.I. from behavioural modelling)?

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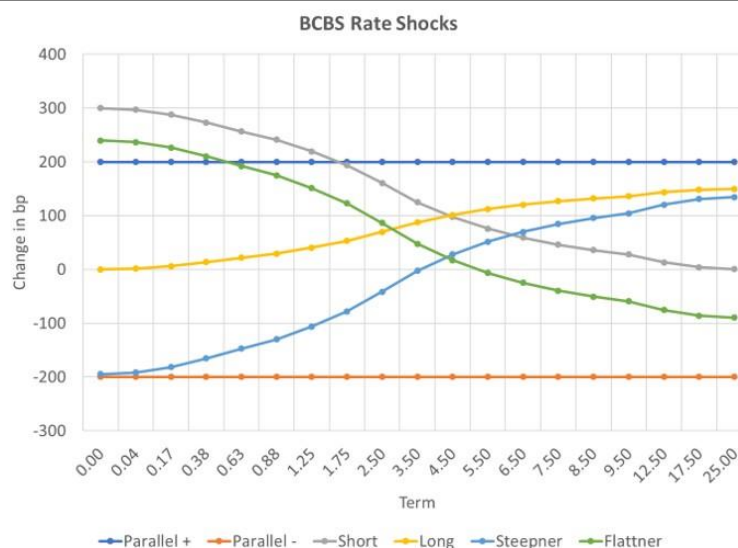

- **How to promote (not to discourage) advances in IRRBB management capabilities:** What are the expectations around using the BCBS standardised framework? Will it be a fall-back in case the internal measurement system does not capture IRRBB adequately? Would implementing the standardised model be considered to be sufficient (for all banks operating locally, or only for some of them), or follow the European Banking Authority guidelines which expects banks to develop and use their own internal approaches (specifically required not to rely on the standardised one). It is not uncommon to observe F.I.s. that are mainly managed using (and to comply with) regulatory metrics, clearly not a best or safe practice that should not be encouraged.

- **Proportionality:** Will this regulation be implemented as a one size fits all approach? Will it only be required for D-SIBs, with only minimal requirements for non-DSIB entities? Here it is worth pointing out, that the absence of specific rules / expectations may lead to regulatory uncertainty for F.I.s. Supervisory reviews for smaller players often tend to "borrow" from practices observed at larger, more complex F.I.s, to set expectations (creating a maximum denominator approach). In order to minimize this, negotiations could include defining those expectations based on some predefined categories. The EBA guidelines provide a good example, defining expectations and criteria for four categories based on size, business model, scope and complexity of their activities.

- **Behavioural assumptions:** BCBS standardised framework establish caps on core deposits and average maturity by category. Should local regulators establish them, and if so at what level? How should the average maturity be calculated? Should there be a cap on maximum maturity (or just disclosure)? If averages and maximums are disclosed, what % of the total NMD balances / segment are they covering?

- **Currency aggregation:** Has proven to be a contentious topic. Banks are required to assess their exposure to different interest rates in different currencies (and consolidated level). Two items stand out:

  - **Currency aggregation:** Under the BCBS guidelines, an advanced approach can use assumptions about the correlation between rates in different currencies (BCBS paragraph 47). Another approach (e.g. BCBS standardised model), is to require banks to calculate EVE exposure as the maximum of the worst aggregated reductions to EVE

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across the six supervisory prescribed interest rate shock scenarios (an unlikely scenario, not based on historical observations). Will banks be allowed to take correlation into consideration? If so, what will be the requirements, including sensitivity / stress analysis around this assumption? How will this impact capital requirements?

- **Minimum coverage, materiality and exposure aggregation in a single currency:** What will be the minimum level of the total balance sheet exposure that should be covered by individual currency measurements and what makes a currency material? The EBA establishes a minimum coverage requirement of 90% of total non-trading book financial assets (excluding tangible assets) or liabilities, with a minimum coverage of 90%. Another relevant aspect is "same" currency aggregation. This should be based on underlying risk factors and local market conditions (level, volatility, etc). Pegged currencies, or exposures to dollarized economies, should not be aggregated on simply on the use of the same unit of account (i.e. due to basis risk). After all, a New York USD dollar is not a (fill in the blank) dollar, as many historical events have shown.

- **Effective requirements (IRRBB, stress testing and ICAAP):** While the direct IRRBB requirements for less complex F.I.s might set as a subset of the G/D-SIB ones (even if based on proportionality), in practice, the required IRR management capabilities to produce meaningful stress test and ICAAP are very similar, requiring banks to model EVE and EAR under different rate scenarios, time horizons, growth assumptions and breakdown of key assumptions to evaluate the forward looking impact on capital adequacy (capital distribution plans) and earnings. F.I.s should consider what the effective expectations are in terms of required resources and capabilities (not to focus only on the direct impact on EVE and EAR measurement)

- **Model risk management:** Given the extent, relevance and potential impact of behavioural assumptions used for IRRBB measurement, the need for a strong, well established model risk management framework cannot be understated. Jurisdictions which have not published relevant guidelines should consider the potential implications and address this point.

With monetary policy and rate levels starting to normalize, rate volatility back in both developed and developing markets, promoting the advancement of Balance Sheet and IRRBB management capabilities will keep us busy in the near future.

Please contact us if you require assistance in developing / implementing your IRRBB framework.

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