PRUDENTIAL REGULATION AUTHORITY POLICY STATEMENT PS26/20

CAPITAL REQUIREMENTS DIRECTIVE V

PART 9: INTEREST RATE RISK IN THE BANKING BOOK

https://www.bankofengland.co.uk/prudential-regulation/publication/2020/capital-requirements-directive-v

DECEMBER 2020

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PS26/20 PART 9: IRRBB

Overview

- EU/EBA CRDV IRRBB requirements will not be implemented in the UK (because they take effect after the Brexit transition period)
- Instead the standards of the Basel Committee on Banking Supervision (BCBS) will be implemented, via changes to:
  - s.9 of the ICAA part of the PRA Rulebook; and
  - the IRRBB section of Supervisory Statement SS31/15 - *The Internal Capital Adequacy Assessment Process* (ICAAP) *and the Supervisory Review and Evaluation Process* (SREP)
- ...effective Friday, 31st December 2021

PS26/20 PART 9: IRRBB

General Requirements (Rulebook, draft ICAA 9.1):

- “A firm must implement systems to identify, evaluate and manage the risk arising from potential changes in interest rates that affect a firm’s non-trading activities including the risks of such changes impacting either or both of the following:
    - (1) the economic value of the firm’s non-trading activities;
    - (2) the earnings in respect of the firm’s non-trading activities
- 9.1A A firm must in addition implement systems to monitor and assess credit spread risk in respect of its non-trading activities”

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High-level provisions: 1

- FSA017 remains in force, but the PRA "intends to consider revising FSA017 in future"

- Additional mandatory new prescribed shock scenarios are added to ICAA (9.7) to test impacts on firms' economic value of equity (EVE):

    - scenario 0: current interest rates;
    - scenario 1: parallel shock up;
    - scenario 2: parallel shock down;
    - scenario 3: steepener shock (short rates down and long rates up);
    - scenario 4: flattener shock (short rates up and long rates down);
    - scenario 5: short rates shock up; and
    - scenario 6: short rates shock down

- The rates involved are prescribed at ICAA 9.11, e.g. (in basis points):

Currency	Parallel	Short	Long
GBP	250	300	150

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High-level provisions: 2

- ***...but*** there are “maturity-dependent post-shock floors” to the rates, starting at -100bps for undated maturities and rising by 5bps each year, to zero for >/=20 years
- Note also that “...when calculating the aggregate change in EVE...positive changes should be weighted by a factor of 50%”
- The EVE shocks in ICAA 9.7 – which must be run at least quarterly – result in changes to a firm’s economic value of equity
- If any scenario reduces EVE by more than 15% of Tier 1 capital (the “outlier test”) the PRA must be notified immediately (and will review the firm's exposure to, and management of, IRRBB)

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High-level provisions: 2 (cont)

- The scenarios must be applied to all “material” currencies
  - A material currency is one which constitutes >5% of total non-trading book assets, or of total non-trading book liabilities...
  - ...but the scenarios must be applied to >90% of total non-trading book assets/liabilities...
  - ...so if currencies constituting >5% of non-trading book assets/liabilities do not sum to >90%, additional currencies must be “deemed” material (presumably in descending order of relative size) until that condition is met, e.g. in the table below, which could be non-trading assets or liabilities, currencies A-D are material:

Currency	Share %	Sum %
A	45	45
B	35	80
C	8	88
D	3	91
E	2	93
Others <2%	7	100

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Note the change of emphasis:

- From the previous IRRBB provisions of SS31/15 regarding the +/- 200bps FSA017 shock (at 2.8)
    - “The level of shock required *may* also be changed in accordance with guidelines issued by the EBA…” (my emphasis)
- to
    - "…the status of the applicable IRRBB requirements would change from an EBA GLs requirement, *with which firms must make every effort to comply*, to binding PRA rules…” (again, my emphasis)
- Note also, from the previous SS31/15 (at 2.11)
    - “The PRA will periodically review whether the level of the shock is appropriate in light of changing circumstances, in particular the general level of interest rates (*for instance, during periods of very low interest rates*)…” (now deleted in the final redraft)

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High-level provisions: 3

- The final new ICAA part 9 and SS31/15 give all firms the option (upon pre-notification to the PRA), but not the obligation, to adopt the BCBS Standardised Framework on IRRBB. The requirements described in this digest are the non-optional 'default'

- Alternatively the PRA may impose use of the Standardised Framework, where it deems that a firm has "deficient internal systems" in respect of IRRBB

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High-level provisions: 4

- The final redraft of the IRRBB section of SS31/15 contains comprehensive requirements regarding
    - Governance, e.g. Board responsibility, the documentation of policies and processes, model risk management, risk appetite and MI, sufficient levels of expertise and independence
    - Data – quality, comprehensiveness, accuracy and timeliness
    - Measurement, over a broad range of different scenarios, of "...gap risk, yield curve risk, basis risk, and risks arising from embedded optionality (e.g. pipeline risk and prepayment risk), as well as changes in assumptions (e.g. those relating to customer behaviour)" wherever material
    - Scenarios must include but not be limited to those economic value scenarios described at ICAA 9.7, but additionally earnings-focused scenarios reflecting the firm's risk profile and "both historical and hypothetical scenarios"

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The range of interest rate shock scenarios should include:

- A wide range of severe, plausible and relevant interest rate shock scenarios...
- ....considering, where relevant, "...gap risk, basis risk, and option risk (including sensitivity to interest rate movements), concentrated risks, and interaction with other risks"
- Vulnerability to reduced economic value or earnings under stressful market conditions – including the breakdown of key assumptions and
- Margin compression
- In addition "...a firm should also use other larger and more extreme shifts and changes in interest rates"

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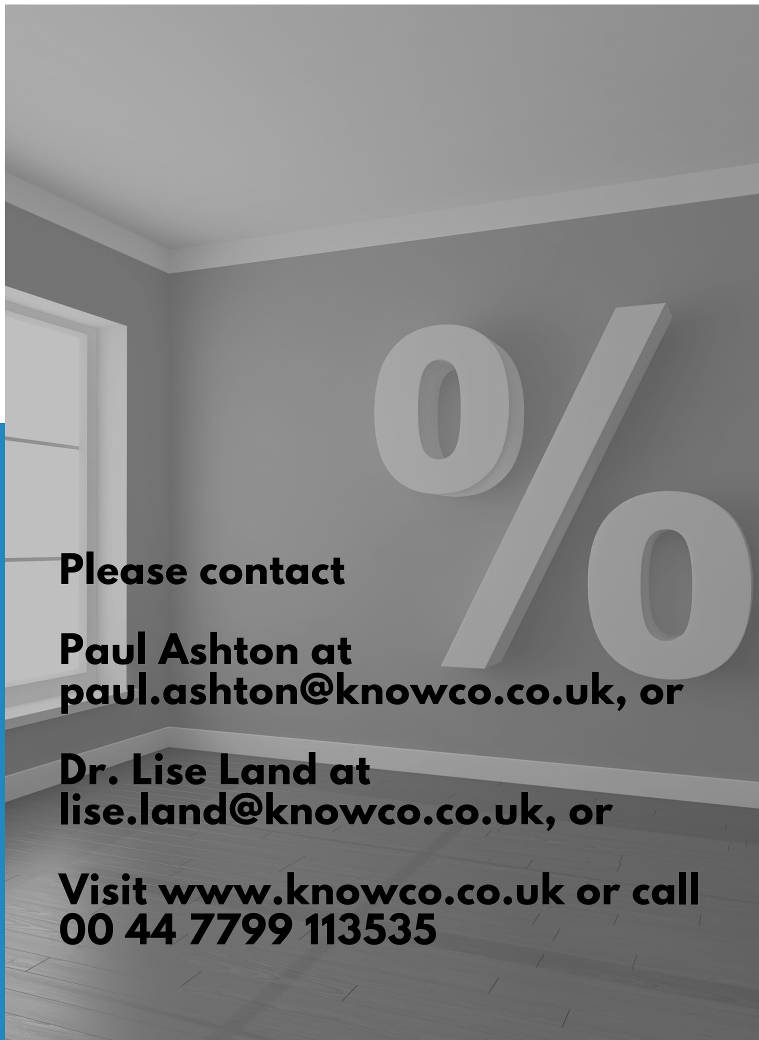

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