Financial Services Management

Interest-Rate Risk-Based Capital

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Impact Assessment

- There is no chance of a costly global IRR capital requirement, leaving this now solely to national discretion most nations will not choose to exercise.
- Nations without rigorous stress-test regimes which take IRR into account will need now to do so, possibly creating additional regulatory-capital requirements based on stress-test results. However, the tests will largely be company-run – not set by supervisory edict – providing considerable flexibility that could undermine remedial action.
- Capital incentives to hold IRR-sensitive positions in the banking book remain largely unaddressed even though HQLA holdings have generally increased bank IRR.
- Mortgage assets will be particularly favored as a result of the decision not to impose a new IRR capital requirement.
- Internal IRR capital-assessments must now be done by regulatory standards and on both an operating-entity and consolidated basis. This could trap IRR in subsidiaries but also ensure their freestanding IRR resilience.
- Banks that trigger outlier status under new standards will be subject to regulatory scrutiny and new risk-management or even capital requirements.
- New public disclosures will be very extensive and include information long considered highly proprietary. Basel believes this necessary to ensure cross-border and cross-industry consistency.

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- Banks without IRR-governance protocols at the board and senior-management level will need to construct these, imposing new governance burdens but increasing the profile of IRR management.

Overview

Addressing interest-rate risk in the banking book (IRRBB), the Basel Committee has decided not to advance possible capital charges outlined in an initial consultation.[1] Instead it is updating its IRRBB principles[2] to lay out a new set of principles that include an array of more stringent guidelines regarding not only capital, but also IRR management, disclosure, and sanctions. The Basel approach also focuses on IRR stress-testing, laying out numerous criteria for company-run tests designed to identify vulnerabilities under even acute stress that then could be remedied with more capital or other actions. The U.S. supervisory and company-run tests[3] already include an IRR component along with many of the internal controls stipulated by Basel for risk management, although U.S. stress tests may be refined to reflect the specific IRR provisions not yet included in current test scenarios.

Impact

The Basel Committee's initial IRRBB consultation was very tentative, proposing either a Pillar 1 capital charge or Pillar 2 controls that might lead to more risk-based capital (RBC). It has decided on the second option not only because banking-industry comments almost uniformly opposed a Pillar 1 charge, but also due to heightened fears that the sum total of all of the Basel III requirements raises minimum capital requirements in a way that forces Basel to concur that a new "Basel IV" has been constructed. Many recent actions and proposals have increased effective RBC despite assertions that Basel's goal is to keep capital more or less consistent with the 2010 Accord for non-GSIBs, and an IRRBB capital requirement would have further raised potential RBC and thus challenged this assertion. As noted, the final version not only backs away from a new capital charge, but is also couched as principles that provide considerable scope for national variation.

Basel appears to recognize this by including in the final standards very detailed public-disclosure requirements which it says will ensure consistency. Because the new disclosures go into considerable detail that may still leave scope for interpretation, it is likely to require sophisticated analytical skills to assess a single bank's IRRBB exposure and even more to compare it to other banks in a single country, let alone in others with different accounting and legal regimes. Perhaps recognizing these challenges, Basel allows banks to supplement its mandatory disclosures with voluntary ones that portray the

[1] See **IRR6,** *Financial Services Management*, June 17, 2015.
[2] See **IRR**, *Financial Services Management*, September 16, 2003.
[3] See Client Reports in the **STRESS** series.

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IRRBB exposure as the bank thinks it can best be described. Supervisors with the necessary expertise may nonetheless gain insight based on public disclosure of information otherwise unavailable to them and enhanced market discipline may contribute to overall IRBB reductions. However, many banks may fear the competitive impact of disclosing information long considered to be highly proprietary.

As noted, Basel's decision to keep the requirements for IRRBB as is does not reconcile the very different treatment accorded IRR in the new market-risk rules applicable to assets in the trading book.[4] The new market-risk rules attempt to address this by specific standards dictating which assets may go into which book, but the capital incentives now reinforced by the Basel Committee's decision on IRR still create a strong tailwind for banks to hold high-risk assets in the banking book wherever possible.

Although Basel does not say so, one reason it may have decided not to pursue an express IRR capital requirement may be the significant cost impact on the large books of high-quality liquid assets (HQLAs) global banks now must hold to meet the liquidity coverage ratio[5] and the net stable funding ratio.[6] In part because of the differences in IRR capital between those applicable at the banking book – now kept low – and the higher ones applicable to the trading book – banks have increasingly decided to put HQLAs into the held-to-maturity positions housed in the banking book. This increases IRR in concert with added capital volatility, but it not only optimizes the RBC otherwise applicable to a large banking organization, but also ensures that even excess HQLAs are there when or if needed. A specific IRR requirement atop the leverage rules applicable to HQLAs could have combined to push HQLAs into the trading book in ways that might undermine available HQLAs under stress scenarios.

Perhaps the most significant strategic effect of Basel's decision to back away from an IRR capital charge is on mortgage lending and/or securitization. This is particularly true in the United States, which is virtually unique with regard to the market dominance of prepayment penalty-free thirty-year fixed-rate mortgages that, even when issued as RMBS, pose significant IRR. An IRR capital standard would have had significant and severely-adverse impact on recent moves by large U.S. banks to hold growing books of fixed-rate mortgages and to include agency RMBS in their bank-investment – not trading – portfolios. Because U.S. Government and GSE-guaranteed mortgages also form a significant part of eligible HQLAs in the U.S., a capital charge for their IRR might have offset or even reversed the otherwise favorable RBC requirements that to some degree reduce the cost of meeting the new liquidity rules. Without this charge, U.S. banks will be free to expand

[4] See **CAPITAL211**, *Financial Services Management*, January 26, 2016.

[5] See **LIQUIDITY9**, *Financial Services Management*, January 15, 2013.

[6] See **LIQUIDITY18**, *Financial Services Management*, November 18, 2014.

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their on-portfolio mortgage business and/or hold government-backed RMBS in the banking book.

However, strategic issues may also result from the requirement that banks now model IRR for internal-capital adequacy assessments on both a unit and consolidated basis. This approach departs from the overall Basel focus on consolidated risk, reflecting a growing regulatory trend to ring-fence capital and liquidity at material operating entities to anticipate host-country demands in stress scenarios. Trapped capital supports subsidiary resilience under stress and, given the link between IRR capital and HQLAs, may also promote their liquidity. However, it also increases the sum total of capital a large banking organization must hold across its consolidated group, adding additional pressure in this critical arena.

The new IRR standards include an array of governance and reporting requirements designed to ensure that boards and senior management take a hands-on, timely role in IRR management, including with regard to setting risk appetites, ensuring that risks remain within these parameters, and assessing whether market changes warrant IRR tolerance revisions. The U.S. already requires liquidity-risk management at the board level for BHCs with assets over $50 billion[7] and heightened OCC risk-management standards do the same for larger national banks.[8] As a result, Basel's requirements here are not likely to have significant U.S. impact but may be significant for banks in many other nations.

What's Next

Basel issued these IRRBB requirements on April 21. Banks are expected to implement them by 2018.

Analysis

The analysis below emphasizes key strategic considerations, not the details needed to ensure adherence to Basel's principles. As noted, the final standards are couched as principles. These stipulate that:

- Banks are to identify, monitor, and manage IRR and credit-spread risk. IRR controls must be specific to products and activities, with substantive advance approval required for major hedging or similar risk-mitigation programs, which should also apply to new products which should also be subjected to testing before full roll-out.
- Boards of directors are ultimately responsible for IRR management, setting the relevant risk appetite (which should be expressed, clear, and consistent with the overall risk appetite) and for holding senior management accountable to ensure this and at least some board members should have

7 See **LIQUIDITY15**, *Financial Services Management*, February 27, 2014.

8 See **RISKMANAGEMENT11**, *Financial Services Management*, September 16, 2014.

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IRR expertise. The board or senior management is to ensure that appropriate limits are in place, that exceptions are carefully vetted, that risk remains within determined boundaries, that controls function as expected, and that assumptions work under stress scenarios to ensure ongoing IRR management and control. The board should be informed at least twice a year about IRR activities and results. As with all risk-management functions, those for IRRBB should be independent of business decisions and be able to report to senior management and the board. The format and content of these reports is specified.

- Banks should shock and stress-test IRR based in part on scenarios included in the final standards. Assumptions should include projections of likely customer behavior and reflect the bank's product mix and complexity.
- IRR measurement should be based on sound behavioral and modelling assumptions that meet criteria stipulated in the principles. These assumptions should also be documented and tested. Basel also specifies that IRR data should be accurate, as one might hope, and subject to documentation, testing, and controls. These are also detailed. Importantly, banks are told not to use a single IRRBB exposure and now to use both economic-value and earnings-based measures. Model development-and-validation standards are also specified, including with regard to the use of third-party models.
- Public disclosures of IRRBB are also to be made, including with regard to the results of shock testing to Basel's specifications. The public should also be told the results of economic-value and earnings-based assessments and much other detail laid out in the final standards. As noted, banks could also use voluntary disclosures to guide supervisors or analysts to the conclusions they think most important.
- Capital adequacy for IRRBB must be included in the internal capital adequacy assessment process (ICAAP) approved by the board in accordance with actual capital and overall risk appetite. The risk to economic value should be the ICAAP driver, with risk to earnings addressed through capital buffers. ICAAP is also to take account of factors detailed in the standards, including their shock scenarios and IRBB at individual units as well as that across the consolidated group otherwise addressed by the standards.
- Supervisors are to ensure they have sufficient IRRBB information, although desired information may vary among supervisors (and thus perhaps lead to different IRR policies, especially with regard to identifying outliers). Capital should also be assessed against the bank's ICAAP estimates, with IRRBB assessments done on both stand-alone and horizontal bases. Sanctions for undue IRRBB could include risk reductions, capital increases, internal-risk parameter reductions, and/or other risk reductions.

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- Supervisors could require use of a standardized IRRBB framework stipulated in Basel's release. Outlier banks could be subject to capital requirements.
- Supervisors are to publish standards for identifying outlier banks.

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