In recent years, credit spread risk in the banking book (CSRBB) has been of minor importance for banks’ market risk measurement and management when compared to “pure” interest rate risk in the banking book (IRRBB). Exception for a few passages in some regulations such as the EBA IRRBB guidelines 2018/02, there are currently no clearly defined requirements for CSRBB management (as of mid 2021). However, due to the economic relevance of CSRBB in the current low interest rate environment, as well as expected regulatory guidelines on the subject, banks have recently become increasingly concerned with the topic. Thus we provide in the following a summary of current regulatory developments, give a market overview on the topic, and describe some practical recommendations for actions.

**Developments in regulatory frameworks**
CSRBB is currently one of the focus areas of European supervisory authorities. This can be seen, among other things, in the increased number of supervisory findings for banks and the inclusion of CSRBB in a Quantitative Impact Study (QIS). In addition, an EBA consultation paper on CSRBB is being developed, either as a stand-alone guideline or as part of updated guidelines on interest rate risk in the banking book.

We expect this consultation paper to be published in the fourth quarter of 2021 or first quarter of 2022, followed by the publication of a final guideline in the first or second quarter of 2022. Our current expectations are outlined in the following roadmap:

**Current developments in regulatory and market practice, upcoming requirements and recommended actions**

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We expect this consultation paper to be published in the fourth quarter of 2021 or first quarter of 2022, followed by the publication of a final guideline in the first or second quarter of 2022. Our current expectations are outlined in the following roadmap:
Based on our experience, there are usually no fundamental changes in the requirements between the consultation papers and the EBA’s final guidelines. For this reason, we recommend that banks follow the consultation phase in detail and communicate any points of discussion or need for clarification to the supervisory authority at an early stage.

Because of this, some banks have already scaled-up their analysis and discussion regarding CSRBB. The current issues and problems faced by market participants are discussed below.

**Developments in market practice and best practice**

CSRBB has not been a primary focus topic of banks in the past. This is due in part to the requirements for CSRBB management being vaguely defined and in part to the different levels of risk exposure among banks. In recent years, the focus of market risks in the banking book has primarily been on “classic” interest rate risks. Many banks did take CSRBB into account in present value risk measurement and the economic ICAAP perspective. However, the methods, models and processes were less developed compared to IRRBB. By contrast, in the periodic perspective (incl. net interest income) credit spread risk has until now played only a minimal role. Recently, however, it can be observed that CSRBB has increasingly become a focus topic of banks. The reasons for this were both the above-mentioned increased regulatory pressure and the greater relevance of credit spread risks for banks’ earnings in the current low-interest rate environment. This is due to the growing usage of securities as a loan substitute and investment product at some banks, and thus an increased relevance of credit spreads for net interest income. In addition, some banks have received loan terminations from their major customers in connection with credit spread changes.

As a result, banks are currently focusing on the following topics and issues – still with an emphasis on the present value perspective:

**I. Definition of positions with Credit-Spread-Risks:** What are the items and portfolios to be considered in CSRBB and what is the impact of the definition of CSRBB on banks’ risks?

**II. Valuation methods and integration into ICAAP:** What are the options for assessing CSRBB and how is it to be integrated into the ICAAP?

In the following, both types of issues are looked at in greater depth, including possible fields of action and recommendations.

### I. Definition of positions with Credit-Spread-Risks

As defined in the EBA IRRBB Guideline (EBA/GL/2018/02), CSRBB comprises “the risk arising from changes in the market perception of the prices of credit risks, liquidity premiums and other possible components of instruments with credit risk that may lead to price fluctuations in these credit risks, liquidity premiums and other possible components that do not fall under IRRBB or expected credit risk/(jump-to-)default risk (risk of sudden default)”. As a rule, only items on the asset side of the balance sheet are considered. The interpretation of this regulatory definition currently still varies widely between European banks, as the regulator has not yet provided further concrete clarification.

Based on the regulatory discussions so far, we do not expect a clear set of criteria that define the scope of CSRBB. Instead the regulator will likely rely on more qualitative criteria, and leave it to banks to define a scope (see current discussions of the German expert panel on IRRBB). Therefore, it is of key importance to understand the current market practice.

For the bank’s internal definition of CSRBB, the following three business characteristics are usually applied in the present value analysis:

- **Type of security:** Loans vs. securities, exchange-traded securities vs. over-the-counter securities, registered debt securities vs. bearer securities,
- **Accounting-category:** Fair Value vs. Amortized Cost
- **Counterparty:** Capital market-oriented companies for which credit spreads can be derived from the market vs. companies for which the credit spreads must be derived from indices or comparable companies vs. private individuals.

These categories can also be identified – at least to some extent – in the last QIS. For example, the risk positions for products with fair value accounting and amortized cost accounting must be reported separately. In addition, a distinction is also made as to whether the valuation of the products is based on market observations (e.g. stock market prices) or not. We therefore expect that the EBA’s definition in the consultation paper will be based on similar criteria.

Along with the three criteria mentioned above, banks define internally which positions are subject to credit spread risks (usually at the level of individual positions or securities). In the area of present value credit spread risks, current market practice can be seen in the chart below:
Overall, a dedicated CSRBB analysis is limited to items on the asset side, in line with statements made by the EBA in the IRRBB Guidelines. There is an increasing trend to consider registered and bearer securities irrespective of the accounting category. As a rule, banks also take into account over-the-counter securities for which the credit spreads are derived from comparable companies or sector/industry indices. The inclusion of corporate loans, on the other hand, is rather uncommon, but is occasionally used for loans of capital market-oriented borrowers accounted for at fair value. The exact definition of CSRBB has a significant impact on the risk position of European banks. This particularly affects those institutions that are increasingly relying on bonds and securities to generate income in the low-interest environment and with rising deposit volumes. If the EBA interprets the CSRBB more broadly than is currently customary in the market, significant effects on market price risk measurement and the ICAAP are to be expected. The first banks have therefore already started to analyze the impact of different definitions of CSRBB on present value risk measures (i.e. scenario- or sensitivity-based analysis, considering different portfolios). We consider this approach advisable, to create awareness of the topic and to better understand the consequences of the future definition of CSRBB for one’s own bank. Furthermore, it is recommended to evaluate the impact of a possible extension of CSRBB scope on data requirements at an early stage.

As will be explained in the following section, it is currently still unusual to measure the CSRBB in the periodic view. Therefore, it remains difficult to derive any statements on the scope of application or the definition. However, it is to be expected that the relevant positions in the future present value and periodic measurement of credit spread risks will remain consistent.

### II. Valuation methods and integration into ICAAP

In risk assessment, a distinction is usually made, in line with the treatment of interest rate risk, between present value risk measurement (EVE) and periodic risk measurement (NII, earnings). In present value risk measurement, the CSRBB is often already taken into account, according to the securities scope defined in section I. Common methods here are historical value-at-risk models or scenario-based present value analyses (economic value of equity), which are also used for consideration in the economic ICAAP. In addition, credit spread sensitivities (CS01) are frequently determined in day-to-day risk measurement. The measurement methods and processes are generally very much based on the "IRRBB world". However, optional components (e.g., options in the securities) are currently not yet fully considered in the CSRBB assessment at many banks. In contrast to IRRBB, for many banks these represent an immaterial aspect of CSRBB.

On the other hand, CSRBB is often not yet considered in periodic risk measurement. With the notable exception of a few "better-practice banks," German and European banks do not treat credit spreads as a relevant driver in net-interest income simulations. Accordingly, very few banks simulate the possible margin effects of a credit spread change. The same applies to the earnings perspective introduced in the IRRBB guideline (EBA/GL/2018/02).

We expect that the periodic risk perspective on credit spread risk, in the context of the new CSRBB guideline, will become relevant and necessary if margin risks from credit spread changes represent a material risk in the period under consideration (usually three to five years). This could entail significant adjustments, and possibly require new concepts, to the established NII and earnings methodologies of German and European banks. Corresponding periodic risks must be taken into account in a normative ICAAP view.

<table>
<thead>
<tr>
<th>Accounting Category</th>
<th>Loans</th>
<th>Registered Bonds</th>
<th>Bearer Bonds</th>
<th>Derivatives</th>
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<td>Amortised Cost</td>
<td>x</td>
<td>x/✓ =&gt; ✓</td>
<td>✓</td>
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Recommendations

The impact of credit spread changes on periodic earnings could be significant at some institutions. These banks will have to consider these risks as part of their risk management strategy. We therefore recommend that banks analyze and quantify at an early stage the extent to which credit spreads are a relevant driver of periodic earnings and risks. To the extent that material risks exist, the impact of CSRBB on the NII methodology should also be evaluated.

In the present value perspective, much will depend on the regulatory guidance regarding the scope of CSRBB. These should be clarified in Q4 2021 and 2022. We recommend that banks begin analyzing the impact of different possible outcomes.

In particular, banks should understand the consequences for their bottom line if they (are required to) include credit spread risks for all securities as well as for all loans to capital market-oriented companies in their economic perspective. Only with this knowledge can a targeted discussion be held with regulators and supervisors during the consultation phase. Their decisions on the CSRBB scope may ultimately require some banks to change their business model. Banks should prepare for this possibility.
Feel free to contact us!
Our experienced experts will be happy to support you in optimally preparing for the requirements of the internal management of credit spread risks in the banking book.

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