Chapter 2

Capital

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2.3 Interest rate risk in the non-trading book

Application

2.3.1 R This section of the *Handbook* applies to a *BIPRU firm*.

2.3.2 G

(1) [deleted]

(2) [deleted]

(3) [deleted]

(4) [deleted]

2.3.3 G Interest rate risk in the *non-trading book* may arise from a number of sources for example:

(1) risks related to the mismatch of repricing of assets and liabilities and off balance sheet short and long-term positions;

(2) risks arising from hedging exposure to one interest rate with exposure to a rate which reprices under slightly different conditions;

(3) risk related to the uncertainties of occurrence of transactions e.g. when expected future transactions do not equal the actual transactions; and

(4) risks arising from consumers redeeming fixed rate products when market rates change.

Purpose

2.3.4 G BIPRU 2.3 sets out more detail on how the systems and controls requirements in *SYSC* and GENPRU 1.2.30 R (Processes, strategies and systems for risks) and the requirements about stress and scenario testing in GENPRU 1.2.36 R apply to interest rate risk in the *non-trading book*.

2.3.5 G BIPRU 2.3 applies requirements that correspond to Article 124(5) of the *Banking Consolidation Directive*.

Proportionality

2.3.6 G The *guidance* on proportionality in BIPRU 2.2 applies to BIPRU 2.3.

Stress testing for interest rate risk: General requirement

2.3.7 R

(1) As part of its obligations under GENPRU 1.2.30 R (Processes, strategies and systems for risks) and GENPRU 1.2.36 R (Stress and scenario tests) a *firm* must carry out an evaluation of its exposure to the interest rate risk arising from its non-trading activities.

(2) The evaluation under (1) must cover the effect of a sudden and unexpected parallel change in interest rates of 200 basis points in both directions.

(3) A *firm* must immediately notify the *appropriate regulator* if any evaluation under this *rule* suggests that, as a result of the change in interest rates described in (2), the economic value of the *firm* would decline by more than 20% of its *capital resources*.

2.3.8 G A *firm* should, under BIPRU 2.3.7 R (2), apply a 200 basis point shock to each major currency exposure.

2.3.9 G For a larger and/or more complex *firm*, appropriate systems to evaluate and manage interest rate risk in the *non-trading book* should include:

(1) the ability to measure the exposure and sensitivity of the *firm*'s activities, if material, to repricing risk, yield curve risk, basis risk and risks arising from embedded optionality (for example, pipeline risk, prepayment risk) as well aschanges in assumptions (for example those about customer behaviour);

(2) consideration as to whether a purely static analysis of the impact on their current portfolio of a given shock or shocks should be supplemented by a more dynamic simulation approach; and

(3) scenarios in which different interest rate paths are computed and in which some of the assumptions (e.g. about behaviour, contribution to risk and balance sheet size and composition) are themselves functions of interest rate level.

2.3.10 G Under GENPRU 1.2.60 R, a *firm* is required to make a written record of its assessments made under GENPRU 1.2. A *firm*'s record of its approach to evaluating and managing interest rate risk as it affects the *firm*'s non-trading activities should cover the following issues:

(1) the internal definition of and boundary between "banking book" and "trading activities" (see BIPRU 1.2);

(2) the definition of economic value and its consistency with the method used to value assets and liabilities (e.g. discounted cashflows);

(3) the size and the form of the different shocks to be used for internal calculations;

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(4) the use of a dynamic and / or static approach in the application of interest rate shocks;

(5) the treatment of commonly called "pipeline transactions" (including any related hedging);

(6) the aggregation of multicurrency interest rate exposures;

(7) the inclusion (or not) of non-interest bearing assets and liabilities (including capital and reserves);

(8) the treatment of current and savings accounts (i.e. the maturity attached to exposures without a contractual maturity);

(9) the treatment of fixed rate assets (liabilities) where customers still have a right to repay (withdraw) early;

(10) the extent to which sensitivities to small shocks can be scaled up on a linear basis without material loss of accuracy (i.e. covering both convexity generally and the non-linearity of pay-off associated with explicit option products);

(11) the degree of granularity employed (for example offsets within a time bucket); and

(12) whether all future cash flows or only principal balances are included.

2.3.11 G The *appropriate regulator* will periodically review whether the level of the shock referred to in BIPRU 2.3.7 R (2) is appropriate in the light of changing circumstances, in particular the general level of interest rates (for instance periods of very low interest rates) and their volatility. A *firm*'s internal systems should therefore be flexible enough to compute its sensitivity to any standardised shock that is prescribed. If a 200 basis point shock would imply negative interest rates or if such a shock would otherwise be considered inappropriate, the *appropriate regulator* will consider adjusting the requirements accordingly.

Stress testing for interest rate risk: Frequency

2.3.12 R (1) A *firm* must carry out the evaluations required by BIPRU 2.3.7 R as frequently as necessary for it to be reasonably satisfied that it has at all times a sufficient understanding of the degree to which it is exposed to the risks referred to in that *rule* and the nature of that exposure. In any case it must carry out those evaluations no less frequently than required by (2) or (3).

(2) The minimum frequency of the evaluation in BIPRU 2.3.7 R (1) is once each year.

(3) The minimum frequency of the evaluation in BIPRU 2.3.7 R (2) is once each quarter.

Consolidation

2.3.13 R GENPRU 1.2.45 R to GENPRU 1.2.59 R (Application of GENPRU 1.2 on a solo and consolidated basis) apply to BIPRU 2.3 as they apply to GENPRU 1.2.30 R and GENPRU 1.2.36 R.