SUPERVISORY AND MARKET FOCUS ON INTEREST RATE AND LIQUIDITY RISKS IN THE BANKING BOOK

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The EBA NII stress test is to be conducted this year, and discussions about its implications are intensifying. At the same time, with the demise of Silicon Valley Bank (SVB), interest rate and liquidity transformation are increasingly gaining the attention of stock exchanges in the US, the UK and Europe. We have just experienced what in 2022 was still regarded as a completely unrealistic scenario: a rise in interest rates, unprecedented in terms of level, speed and form, that has taken many credit institutions by surprise. Regardless of the banks' actual exposure, almost all bank stocks have therefore come under massive pressure over the past days. Terms such as bank bailout and financial crisis are once again being bandied about. Quick solutions are being sought. Tighter regulations are being called for.

1. Identification of weaknesses in bank management in times of rising interest rates
2. Analytical framework for bank management
3. Holistic view of the bank remains essential

Identification of weaknesses in bank management in times of rising interest rates

The aim of this short article is not to analyze the SVB's situation or to make comparisons with other market participants. Ultimately, interest rate and liquidity risks in banking books must always be reviewed very specifically for each bank. Sweeping statements aimed at entire groups of banks will inevitably lead to false conclusions. Instead, we would like to encourage readers not to underestimate the complexity of the subject. The implications of the recent interest rate rises and further increases to be expected in the near future affect almost all areas of bank management.

In the following, we would like to briefly present an analytical framework that we have applied at many institutions from a wide range of banking groups in recent weeks and months. Using this framework made it possible to identify and eliminate weaknesses in management. In specific cases, it even uncovered earnings potential.

Banks should urgently challenge their positioning in four management areas:

Treasury/ALM

Sales management and pricing

Internal risk controlling

Accounting and regulatory requirements Formularende

Analytical framework for bank management

Below, we would like to provide initial suggestions for these four key areas of analysis and conclude by suggesting that the topic be considered holistically, since the respective issues are closely interwoven and partly also interdependent.

I) Treasury/ALM

In the field of "Treasury/ALM", it will be necessary to reassess the extent to which maturity transformation leads to an adequate risk-return profile from an interest rate and liquidity perspective. Similarly, with a view to holistic balance sheet management, it will also be necessary to examine whether the funding and asset mix may not be sufficiently diversified after all.

II) Sales management and pricing

In the course of the prolonged period of low interest rates, sales units often favored long-term mortgage loans, while deposits were sometimes seen as a burden on net interest income. With the interest rate turnaround, however, the situation has done a one-eighty. The competition for customer deposits is heating up again, and those long-term loans are likely to turn into a burden in future. Deposits have gone back to driving revenues, but at the same time remain an Achilles' heel for many banks, as the case of SVB has shown.

Model assumptions on the interest rate adjustment behavior of assets and liabilities, i.e. interest rate elasticities, need to be reviewed just as much as hypotheses on deposit bases and volume shifts. Sales strategies may need to be adjusted, which also applies to funds transfer pricing.

III) Internal risk controlling

There is no doubt that the increased volatility in the markets, in conjunction with expected balance sheet volume shifts, should result in the need for a reassessment of the significance of transformation risks from the perspective of internal risk and controlling bodies. On the one hand, it may be necessary to make fundamental adjustments in risk strategy and risk appetite. In many banks, the effects of the interest rate hike have led to an almost complete exhaustion of hidden reserves.

As a result, the situation with regard to absorbing further shocks is very different from a year ago. On the other hand, individual institutions will also have to reinvest

in their own infrastructure. For example, the non-occurrence of risk cases in recent years has led to an investment backlog in terms of people and IT at some banks, which means that the rapid scenario analyses or the comprehensive assessment of model risks that would be so urgently required are simply not possible today.

IV) Accounting and regulatory requirements

Depending on the accounting standard applied, the implications that changes in interest rates or volumes will have on the income statement need to be examined as soon as possible. Discussions are currently focusing on the topics of “hedge accounting” and “valuation of the banking book”. Especially in times of rising interest rates or disjointed interest rate and liquidity transformations, P&L volatility can significantly increase very quickly.

Similarly, there is a stronger need to review whether the current positioning or planned adjustments fit within the regulatory framework. That said, some uncertainties cannot be completely eliminated at present. While LCR and NSFR can be measured unambiguously, the specifications for the NII stress test or the periodic outlier calculation are still in flux and not yet final. Holistic view of the bank remains essential delegating responsibility for analyzing these and other issues to the individual departments would at best lead to partial answers, which may then not be possible to implement from a holistic perspective. In our experience, it is more appropriate to take an integrated finance and risk management perspective and record the status quo using a practice-proven checklist. This inventory can then be used to efficiently and objectively derive the adjustments and management decisions that may be necessary.

Certainly, this short article cannot comprehensively cover all relevant facets of the topic. The authors are available for further discussions at any time.