Guideline Impact Analysis Statement
Guideline B-12 - Interest Rate Risk Management

1. Background

Interest rate risk (IRR) has historically been associated primarily with financial products held in the trading books of federally regulated deposit taking institutions (DTI). However, in the current environment, it is recognized that the majority of the interest rate risk (IRR) incurred by DTIs is in fact based in the banking book. These risks arise from products such as guaranteed deposits and mortgages.

Low rate environments, such as those recently experienced, are conducive to DTIs generating profits by assuming IRR. At its most basic level, value is created when long-dated loans are funded by short-term obligations. However, problems can arise when short-term rates rise, thereby compressing the "spread" that DTIs earn between their assets and liabilities. As exemplified through the savings and loans scandal in the United States, IRR is a potential source of systemic risk to the financial system unless it is adequately measured and contained by DTIs.

Recently, the Basel Committee on Banking Supervision has developed guidance (*Principles for the Management and Supervision of Interest Rate Risk*) in support of its Pillar 2 approach in the new capital framework (Basel II). Under Basel II, these principles form minimum standards by which banks are expected to manage their IRR exposures.

2. Problem Identification

Traditionally, regulatory attention to IRR has focused on the trading book. As a result, there has been insufficient guidance regarding policies and procedures for dealing with IRR in the banking book. OSFI undertook a review of IRR management (the IRRMA project) in 2002 that noted significant variations in the definition and measurement methodologies used by DTIs. In addition, the review suggested that approaches to stress testing were rudimentary, and public disclosure was inconsistent.

3. Objectives

OSFI's objective with respect to issuing guidance on IRR is to define and narrow the range of acceptable practices in IRR management and set forth the criteria against which IRR will be assessed across DTIs.

4. Option Identification and Assessment

Option 1: *Adopt Guidance Issued by the Basel Committee*

Under this option OSFI would rely solely on the guidance provided by the Basel Committee. The Basel document outlines basic principles regarding the management of IRR, which all complex DTIs in Canada currently fulfill. As such, the costs to DTIs and OSFI would be negligible.

However, simply adopting the Basel guidance provides limited value-added since it would result in OSFI obtaining the same data pool that was assessed in the IRRMA project. In addition, there would not be any mechanism for OSFI to import best practices observed in trading books to the banking book (e.g. segregation of duties). Lastly, it would not address the unique regulatory expectations in Canada (i.e. increased accountability of the Board of Directors and Senior Management, and the expectation that a funds transfer pricing (FTP) mechanism be in place).

Option 2: *Issue a Guideline In Support of the Basel Guidance*

Under this option OSFI would issue a guideline in support of the Basel Committee's document. The guideline would highlight principles in the Basel document that, in OSFI's opinion, are crucial components of a sound IRR management framework. In addition, the guideline would allow OSFI to introduce additional criteria on which DTIs will be evaluated (such as the existence of an FTP mechanism, sensitivity to shifts in the yield curve, etc.).

Costs to OSFI associated with this option would be limited since it has been developed from pre-existing sources (the Basel guidance and the "best practice" identified as part of the IRRMA review). Generally speaking, the costs to DTIs will also be limited since most DTIs with material IRR exposure already practice transfer pricing; thus the only additional requirement would be measuring sensitivity to specified stress test conditions.

5. Consultations

OSFI consulted extensively with the industry through its interest rate risk review and assessment project conducted in 2002-2003. OSFI also undertook preliminary consultations with several financial institutions during the development of the IRR guidance. Based on the consultative process, OSFI decided that a concise guideline endorsing the principles outlined in the Basel Committee's *Principles for the Management and Supervision of Interest Rate Risk* would communicate OSFI's expectations as effectively as more detailed guidance. Finally, the Guideline was issued as a draft in December 2004 in order to provide the financial services industry with an opportunity for additional stakeholder input. As a result of feedback received, OSFI made a number of clarifications to the Guideline, including the addition of a requirement for DTIs to measure the effect of a 25 basis point shock.

6. Recommendation

OSFI has chosen Option 2 since it will provide DTIs with additional guidance and transparency on the aspects of IRR management that are of particular interest to OSFI. As such, the Guideline should assist DTIs in further developing comprehensive processes and methodologies. From a regulatory perspective, Option 2 allows OSFI to obtain a comparable and meaningful set of data on which to assess DTIs. The ability to conduct robust assessments will help to ensure that DTIs are effectively managing IRR.