Banking Supervision Department
Jerusalem, December 20, 2023
Circular Number C-06-2766

Attn:
Banking corporations and Acquirers

Re: Interest Rate Risk in the Banking Book
(Proper Conduct of Banking Business Directive no. 333)

Introduction

1. Interest rate risk in the banking book (IRRBB) refers to the current or prospective risk to the banking corporation's capital and earnings arising from adverse movements in interest rates that affect the banking book positions. Excessive IRRBB can pose a significant threat to a banking corporation's current capital base and/or future earnings if not managed appropriately.
2. In April 2016, the Basel Committee published an updated document on the issue of IRRBB. The update of the Directive reflects the adoption of the Basel Committee's revised document, as it appears in the Basel Committee documents (SRP31 and SRP98, hereinafter, "the updated document"). Therefore, the current Directive will replace the existing Proper Conduct of Banking Business Directive no. 333—"Management of Interest Rate Risk" (hereinafter, "the Directive that was replaced").
3. The Directive establishes principles, on the basis of which a banking corporation is required to manage its IRRBB, and in particular, requirements for effective IRRBB identification, measurement, monitoring, control, and disclosure. The Directive's main updates to the IRBBB principles for management of interest rate risk are as follows: more detailed guidance regarding the expectations for a banking corporation's IRRBB management process, and in particular the issue of the development of interest rate shock and stress scenarios in implementing IRRBB (Principle 4), on the issue of behavioral assumptions and model assumptions for managing the IRRBB (Principle 5), and the issue of the internal validation process that is to be implemented for the internal measurement systems (IMS), and the models used for IRRBB (Principle 6), the standardized framework for managing IRRBB (optional or mandatory, to be decided by the Supervisor of Banks); a new definition of "Outlier banking corporation" (reflected in Principle 12).
4. The regulation was not accompanied by the publication of a report under the Principles of Regulation Law, 5782-2021, in view of the significant activity carried out before the Law went into effect, in accordance with the Governor's decision.
5. After consulting with the Advisory Committee on Banking Business Affairs and with the approval of the Governor, I have replaced this Proper Conduct of Banking Business Directive with the new Directive, as detailed below.

The Updated Sections of the Directive:

General (Chapter A)
General guidelines, including definitions of main terms used in this Directive.

6. **Explanatory notes:**
The Directive adopts the Basel Committee's updated document on this issue. The Directive emphasizes IRRBB, but this does not make redundant the requirement to manage interest rate

risk in general (in the banking book and the trading book). The application of the Directive remains identical to that of the Directive that was replaced, but certain adjustments were made for a foreign bank or an acquirer, due to the characteristics of those corporations and the separation of credit card companies from banks in view of the legislation of the Increasing Competition and Reducing Concentration in the Banking Sector in Israel (Legislative Amendments) Law, 5777-2017.

In addition, the chapter with definitions was adjusted for the contents of the Directive.

7. Definition of IRRBB (Chapter B)

Explanatory notes:

The chapter includes details of the nature of IRRBB (in the banking book and in general), and the main sub-types of interest rate risk. Added to this chapter was a reference as well to credit spread risk in the banking book. This risk is a related risk to IRRBB, and the banking corporation is to monitor and assess its level.

8. **Principles for managing IRRBB (Chapter C)**

   a. The new Directive sharpens the list of principles for managing IRRBB and establishes that the implementation of these principles should be commensurate with the bank's nature, size and complexity (Sections 4–5).

   b. The Directive details the principles for managing interest rate risk that the banking corporation is required to implement. The principles include, among other things, the corporate governance arrangements in IRRBB management, identification, and monitoring the risk, delineating the risk (beginning with the risk appetite through limitations and sublimitations), articulating the risk both in terms of economic value and in terms of earnings, use of various scenarios, including stress scenarios, the careful dealing with instruments with behavioral optionalities, and assumptions that served to model them in order to estimate the risk, managing the model risks for managing the IRRBB, reporting to the board of directors and senior management, as well as appropriately handling risk within the framework of Pillar 2.

   c. A central principle was added (Principle 12), which does not exist in the Directive that was replaced, regarding how the Supervisor defines outlier banking corporation with regard to IRRBB.

   d. Standardized interest rate shock scenarios were established.

Explanatory notes:

The principles included in this chapter include quality-related guidelines regarding the manner of managing the risk at a banking corporation. These principles include more detailed guidelines, compared to the directive that was replaced, with emphases on issues such as basing the measurement on economic value indices and earnings-based measures, stress scenarios, model risk management and the assumptions that are at the base of the model.

Principles 10–11 are intended for the supervisor and are not included in the Directive. Principle 12 reflects the requirements of the banking corporation in order to enable the supervisor to identify an outlier banking corporation concerning exposure to IRRBB.

The directive defines the term "outlier banking corporation" and gives it new content via the requirement to implement 6 predefined interest rate shock scenarios. Six scenarios are of the economic value of the capital (marked as 1–6), and 2 scenarios (marked 1–2) are for net interest income. An outlier banking corporation will be identified as one that with the maximum change in the economic value of the capital, calculated based on the six scenarios, is worth or exceeds 15 percent of the banking corporation's Tier 1 Capital. The supervisor could implement additional tests to identify an outlier banking corporation.

9. The standardized framework (Chapter D)

a. The chapter includes certain guidelines regarding the measurement of IRRBB on the basis of economic value of the economic value of the capital, and in particular regarding the measurement of cash flows.
b. The Supervisor could require a banking corporation to adopt this framework, in whole or in part, in the current management of IRRBB; in any other case, a banking corporation is permitted to adopt this framework.

Explanatory notes

This chapter establishes new directives that did not appear in the directive that was replaced. Within the framework of this Chapter, a more uniform framework was defined for estimating and managing interest rate risk. The Supervisor of Banks may require a banking corporation to adopt the framework, in whole or in part, for example, if the Supervisor is of the view that the quality of interest rate risk management is not adequate. In addition, a banking corporation may choose to estimate the interest rate risk and manage it accordingly. Parts of this chapter were adopted by the Supervisor of Banks to calculate standardized interest rate shocks (Appendix 1A) in order to allow a better basis for comparing the results presented by the banking corporations.

10. Appendix 1—Definition of IRRBB

c. The first part of the Appendix (Sections 1–55) includes a more detailed description of the IRRBB and techniques to measure it. This part serves as background, and does not contradict the requirements in the Directive.

d. The second part of the Appendix (Sections 56–63) defines the manner of calculating the size of the interest rate shocks included in Section 90 of the Directive and serve to calculate the standardized interest rate shocks for identifying an outlier banking corporation.

Explanatory notes

Similar to the Directive that was replaced, in this Directive as well there is an Appendix that describes in more detail the various methods of analyzing and quantifying the components of interest rate risk. The second part of the Appendix replaces Appendix 2 in the previous directive, with regard to the manner of calibrating interest rate shocks. The guidelines regarding the manner of calculating the impact of interest rate shocks are included in Appendix 1a (for a banking corporation) and Appendix 2 (for an acquirer).

11. Appendix 1a: Establishing additional assumptions for calculating standardized interest rate shocks

Explanatory notes

Appendix 1a includes guidelines for calculating the impact of standardized interest rate shocks. The guidelines in Sections 1 and 2 of this Appendix are based on the guidelines included in the disclosure to the public (Pillar 3) and on the guideline for measuring adjusted net fair value, as defined in the Reporting to the Public Directives. For the avoidance of doubt, the standardized shocks in the Directive and the standardized shocks in the disclosure requirements will be adjusted and unified.

Section 3 deals with a currency scheme for calculating the impact on the economic value and Section 4 deals with guidelines within the standardized framework that have been integrated in order to enhance the uniformity in calculating the standardized interest rate shocks by the banking corporations.

The guidelines regarding the manner of calculating the impact of the standardized interest rate shocks were added in the revised Basel directive and adopted in this Directive.

It is emphasized that for the purpose of internal management of IRRBB, a banking corporation may establish other scenarios and different assumptions.

12. Appendix 2 – Standardized interest rate shocks for an acquirer

Explanatory notes

Appendix 2 includes an adjustment of standardized interest rate shocks that will be imposed on an acquirer, in view of the activity characteristics of acquirers. The standardized interest rate shocks required of an acquirer are parallel scenarios of an increase in the interest rate and a decrease in the interest rate.

Application

13. The start date of the amendments to the Directive pursuant to this circular shall be July 1, 2025.

File update

14. Update pages for the Proper Conduct of Banking Business Directives file are attached. The following are the update instructions:

Remove page	**Insert page**
333-1-30 [2] (9/21)	333-1-30 [3] 12/23)

Respectfully,

Daniel Hahiashvili
Supervisor of Banks