Republic of Latvia

Latvijas Banka

Regulation No. 254

Adopted 27 November 2023

**Regulations for the Management of Interest Rate Risk of the Non-trading Book and Credit Spread Risk of the Non-trading Book**

*Issued pursuant to*

*Section 34.2, Paragraph four, Section 50, Paragraph two, Section 101.3, Paragraph five of the Credit Institution Law*

**1. General Provisions**

1. The Regulation prescribes the following for the credit institutions registered in Latvia, investment firms referred to in Section 11.2 of the Credit Institution Law, and investment firms referred to in Article 1(2) and (5) of Regulation (EU) 2019/2033 of the European Parliament and of the Council of 27 November 2019 on the prudential requirements of investment firms and amending Regulations (EU) No 1093/2010, (EU) No 575/2013, (EU) No 600/2014 and (EU) No 806/201 (hereinafter together – the institution):

1.1. the minimum requirements and procedures by which the institution manages, including identifies, evaluates, analyses, and controls the interest rate risk of the non-trading book;

1.2. the minimum requirements and procedures by which the institution evaluates and controls the credit spread risk of the non-trading book;

1.3. the criteria and procedures by which Latvijas Banka determines that the internal systems implemented by the institution for the evaluation of the interest rate risk of the non-trading book are not satisfactory in accordance with the requirements of Section 49.2 of the Credit Institution Law;

1.4. the procedures for calculating the reduction in the economic value of own funds of the institution due to sudden and unexpected changes in interest rates as set out in any of the supervisory stress scenarios applied to interest rates in accordance with the directly applicable legal acts of the European Union.

2. The following terms are used in the Regulation:

2.1. components of the interest rate risk of the non-trading book (hereinafter – the interest rate risk):

2.1.1. basis risk – the risk of incurring losses as interest rates change against interest rate sensitive instruments with the same review or maturity but different base rates;

2.1.2. spread risk – the risk of incurring losses due to imbalanced term structure of interest rate sensitive instruments, covering changes in the term structure of interest rates which occur consistently across the whole yield curve (parallel risk) or differently across time intervals (non-parallel risk);

2.1.3. optionality risk – the risk of incurring losses when interest rate sensitive instruments directly (for example, options) or indirectly (for example, credits with an early repayment option, demand deposits, time deposits with an early withdrawal option, fixed rate loan commitments, etc.) provide the institution or customer of the institution with the option to change the amount and timing of the cash flow;

2.2. interest rate sensitive instruments – assets (including non-performing loans that reflect the expected cash flows and timing thereof less any impairment loss recognised in the financial statements in accordance with Commission Regulation (EC) No 1126/2008 of 3 November 2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council, and also interest rate derivatives, derivatives linked to interest rates), liabilities (including interest rate derivatives, derivatives linked to interest rates, demand deposits) and off-balance sheet positions of the non-trading book (including interest rate sensitive loan commitments, interest rate derivatives, other derivatives other than interest rate derivatives but referencing the interest rate) that are sensitive to changes in interest rates, except for assets deducted from Common Equity Tier 1 within the meaning of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (hereinafter – Regulation No 575/2013);

2.3. non-performing loan – an exposure that is a non-performing exposure within the meaning of Article 47a of Regulation No 575/2013;

2.4. credit spread risk sensitive instruments – assets, liabilities, and off-balance sheet positions (including credit spread risk sensitive financial liabilities) in the non-trading book which are sensitive to changes in credit spread risk, except for the assets deducted from Common Equity Tier 1 within the meaning of Regulation No 575/2013;

2.5. market credit spread – the credit risk premium demanded by market participants for the respective credit quality;

2.6. market liquidity spread – the liquidity premium for market demand in respect of investments and the existence of buyers and sellers;

2.7. residual maturity – the time from the last day of the evaluation period to the end date of the contract or the date when the respective amount is to be repaid or interest rates are to be reviewed in accordance with the terms of the contract;

2.8. economic value – the net present value of the cash flow over the residual maturity in the case of interest rate risk for interest rate sensitive instruments and in the case of credit spread risk for credit spread risk sensitive instruments in the non-trading book;

2.9. conditional cash flow modelling – a cash flow modelling technique when the amount or timing of cash flow depends on a specific scenario for changes in interest rates;

2.10. unconditional cash flow modelling – a cash flow modelling technique when the amount and timing of cash flow does not depend on a specific scenario for changes in interest rates;

2.11. run-off balance sheet – a balance sheet, including on- and off-balance sheet items where existing non-trading book positions amortise and are not replaced by any new positions;

2.12. material currency – a currency in which the carrying amount of denominated assets or liabilities is at least 5 per cent of the total financial assets or liabilities of the non-trading book or less than 5 per cent if the sum of financial assets or liabilities included in the calculation is less than 90 per cent of the total financial assets (excluding tangible assets) or liabilities of the non-trading book;

2.13. sensitivity analysis – a stress test intended to evaluate the potential impact of a specific risk factor or several simple risk factors on a particular instrument, portfolio, or institution;

2.14. scenario analysis – an evaluation that indicates how an institution or a respective portfolio can withstand a specific scenario consisting of a set of risk factors and conforming to all of the following characteristics:

2.14.1. the risk factors are harmonised;

2.14.2. the risk factors forming the specific set envisage simultaneous occurrence of forward-looking events that cover risks and entrepreneurship areas;

2.14.3. the aim of the set of risk factors is to reveal as much as possible the nature of the associated risks of the portfolios, including over time, at the level of interaction, and the secondary effects thereof.

3. Institutions supervised by the European Central Bank and bounded by the requirements laid down by the European Central Bank for the management of interest rate risk and for the assessment and supervision of credit spread risk in the non-trading book (hereinafter – the credit spread risk) shall apply this Regulation, unless the European Central Bank has laid down requirements for the management of interest rate risk and for the assessment and supervision of credit spread risk.

4. The institution shall comply with the requirements of this Regulation individually and at the level of the prudential consolidation group or on a sub-consolidated basis within the meaning of Regulation No 575/2013, ensuring that the interest rate risk is managed and the credit spread risk is assessed and supervised in compliance with the requirements of this Regulation.

5. When applying the requirements contained in this Regulation and establishing a system for the management of interest rate risk and for the assessment and supervision of credit spread risk which is suitable for its operations, the institution shall take into account the following:

5.1. the amount of the current and potential exposures exposed to the interest rate risk and credit spread risk, depending on the size, complexity, and diversity of the non-trading book positions;

5.2. the size, nature of work, business model, and operational strategy of the institution;

5.3. the current and foreseeable business environment conditions;

5.4. the potential impact of the interest rate risk and credit spread risk on the continuity of the institution’s operations;

5.5. the number of units involved in the management of interest rate risk and in the assessment and supervision of credit spread risk, including specialists with an appropriate qualification and experience;

5.6. the risk profile and general approach to risk management to ensure that the systems for the management of interest rate risk and credit spread risk are aligned with the general approach to risk management;

5.7. any other factors that significantly affect the level of interest rate risk and credit spread risk of the specific institution.

6. The institution shall continuously manage the interest rate risk and assess and supervise the credit spread risk throughout the entire existence of the transaction exposed to the interest rate risk and credit spread risk in respect of both economic value and net interest income, additionally taking into account changes in the market value of instruments measured at fair value. The institution shall take into account an increase or decrease in profit, loss, and own funds for the short and medium term resulting from changes in interest rate or credit spread risk.

7. The institution shall determine changes in net interest income as a difference between the expected net interest income according to the stress scenario, assuming that the institution will continue to operate, and the expected net interest income according to the baseline scenario which is based on the forecasts for operations of the institution, economic development, and business environment. Net interest income shall include interest income and interest expense.

8. When determining changes in economic value or economic value of own funds as a difference between the expected economic value or economic value of own funds according to the stress scenario and the expected economic value or economic value of own funds according to the baseline scenario respectively which is based on the forecasts for operations of the institution, economic development, and business environment, the institution shall take into account the run-off balance sheet. The economic value of own funds shall reflect the economic value, excluding own funds from the cash flow.

9. The institution shall determine changes in the market value of instruments in the non-trading book which are measured at fair value at the end of the assessment period as a difference between the expected market value according to the stress scenario, assuming that the institution will continue to operate, and the expected market value according to the baseline scenario which is based on the forecasts for operations of the institution, economic development, and business environment.

10. The institution shall ensure that its process of the management of interest rate risk and the assessment and supervision of credit spread risk is documented, including:

10.1. the institution’s internal normative documents (including policies, procedures, by-laws, instructions) regarding the management of interest rate risk and the assessment and supervision of credit spread risk are documented and approved at an appropriate management level;

10.2. all assumptions made in the management of interest rate risk and the assessment and supervision of credit spread risk, including stress testing, are documented, and also the impact of these assumptions on the overall results is analysed;

10.3. results of the assessment of interest rate risk and credit spread risk are documented and approved by the responsible body of the institution and at least once in a calendar quarter at a relevant management level in accordance with the procedures laid down by the institution.

11. The requirements of this Regulation for the interest rate risk shall be applicable to all interest rate sensitive instruments, including pension plan assets and pension liabilities, and also small trading book business identified in accordance with Article 94 of Regulation No 575/2013 if the assessment of the interest rate risk thereof is not included in the management of another risk. The interest rate risk shall reflect the current and potential future adverse impact of changes in interest rates which affects the interest rate sensitive instruments in the non-trading book on the economic value of own funds of the institution or net interest income, additionally taking into account changes in the market value of instruments measured at fair value.

12. The requirements of this Regulation for the credit spread risk shall be applicable to all interest rate sensitive instruments, except for non-performing loans, all instruments in the non-trading book measured at fair value, and also small trading book business identified in accordance with Article 94 of Regulation No 575/2013 if the assessment of the credit spread risk thereof is not included in the management of another risk. When assessing the credit spread risk, the institution shall take into account that it arises from changes in the market price of credit risk, liquidity, and other characteristics of the instruments exposed to the credit risk which cannot be explained by the interest rate risk or expected default risk or credit risk, assuming that the level of creditworthiness (for example, credit rating, default probability) remains unchanged, i.e. the credit spread risk does not include the impact of changes in credit quality. In particular, negative changes in the institution’s credit quality may not positively affect the level of credit spread risk. The institution shall properly justify and document clear, objective, and transparent information on the exclusion of any instrument reflected in the non-trading book from the assessment and supervision of the credit spread risk due to the absence of sensitivity to changes in the credit spread and on the exclusion process.

13. Requirements of this Regulation shall be applicable to all areas of operations and services of the institution with the interest rate risk and credit spread risk.

14. Supervisory board and executive board of the institution shall be responsible for the establishment and efficient functioning of the process of managing the interest rate risk and assessing and supervising the credit spread risk, ensuring that members of the supervisory board and executive board have sufficient knowledge and experience and they dedicate sufficient time to address the issues related to the management of interest rate risk and the assessment and supervision of credit spread risk.

**2. Interest Rate Risk and Credit Spread Risk Strategy and Internal Normative Documents for Implementation Thereof**

15. The institution shall ensure that the process of managing the interest rate risk and assessing and supervising the credit spread risk is an integral part of the institution’s risk management system, capital adequacy assessment, and operational planning.

16. The institution shall ensure the management of interest rate risk and the assessment and supervision of credit spread risk, taking into account interaction thereof with other risks inherent to the operations of the institution, such as market risk, liquidity risk, operational risk, credit risk.

17. The institution shall ensure that the interest rate risk and credit spread risk strategy is part of the institution’s overall risk strategy which is aligned with the process of assessing capital and liquidity adequacy.

18. The interest rate risk strategy shall determine at least the following:

18.1. objectives of efficient management of interest rate risk;

18.2. basic principles for the management of interest rate risk;

18.3. the acceptable level of interest rate risk that the institution is willing to obtain by taking the relevant interest rate risk;

18.4. the desired level of interest rate risk as the acceptable impact of changes in interest rates on economic value and net interest income, additionally taking into account changes in the market value of instruments measured at fair value;

18.5. the ultimate possible level of interest rate risk that the institution is able to cover with available resources;

18.6. actions to ensure compliance with the acceptable level of interest rate risk;

18.7. the amount of capital necessary to cover the interest rate risk and changes thereof, applying different economic development scenarios and solutions that the institution intends to apply if the institution cannot comply with the own funds requirements in any of the scenarios;

18.8. prescribed methods for mitigating the interest rate risk, including the acceptable strategies for hedging the interest rate risk and the instruments to be used, and also the potential consequences of mitigating the interest rate risk by using derivatives.

19. The credit spread risk strategy shall determine at least the following:

19.1. objectives of efficient assessment and supervision of credit spread risk;

19.1. basic principles for the assessment and supervision of credit spread risk;

19.3. the acceptable level of credit spread risk;

19.4. the desired level of credit spread risk as the acceptable impact of changes in credit spread on economic value and net interest income, additionally taking into account changes in the market value of instruments measured at fair value, depending on the exposure to credit spread risk;

19.5. the ultimate possible level of credit spread risk that the institution is able to cover with available resources;

19.6. actions to ensure compliance with the acceptable level of credit spread risk;

19.7. the amount of capital necessary to cover the credit spread risk, where necessary, and changes thereof, applying different economic development scenarios and solutions that the institution intends to apply if the institution cannot comply with the own funds requirements in any of the scenarios.

20. Determination of the acceptable and desired levels of interest rate risk and credit spread risk and other parameters of interest rate risk and credit spread risk shall be based on the results of the assessment of the institution’s ability to take the interest rate risk and credit spread risk, including on assessments of economic value and assessments of net interest income, and assessments of changes in the market value of instruments in the non-trading book measured at fair value.

21. If the institution’s business model is based on generating net interest income by using the yield curve, namely by combining financial assets with a comparatively long repricing period and liabilities with a comparatively short repricing period, the institution shall specify in its interest rate risk strategy how it intends to overcome periods with a flat or inverse yield curve.

22. The institution arranging significant transactions exposed to spread risk, basis risk, and optionality risk shall determine the desired level of interest rate risk and other parameters characterising interest rate risk separately for the spread risk, basis risk, and optionality risk.

23. The institution shall establish criteria for identifying materiality for the components of interest rate risk specified in Paragraph 22 of this Regulation.

24. In determining the desired level of interest rate risk in respect of both economic value and net interest income, additionally taking into account changes in the market value of instruments measured at fair value, the institution shall take into account at least the following:

24.1. the impact of accounting policy on net interest income risk, separately analysing the impact of changes in interest rates on interest income, interest expense, and market value of instruments reflected in both the profit or loss statement and other comprehensive income included in the own funds item;

24.2. the potential impact of interest rate derivatives used for hedging risk on the profit or loss statement if the effectiveness of the respective instruments is limited by changes in interest rates;

24.3. the impact of instruments measured at fair value with embedded optionality on net interest income at various stress levels of stress test of interest rates, namely from the baseline scenario which is based on the forecasts for operations of the institution, economic development, and business environment to a significant unfavourable scenario.

25. The institution shall determine the ultimate possible levels of interest rate risk and credit spread risk, taking into account other risks inherent to the operations of the institution resulting from the risk strategy of the institution.

26. When taking the decision on activities hedging the interest rate risk, the institution shall take into account the impact of accounting policy, however, the accounting methods may not determine the approach to the management of interest rate risk.

27. When developing the interest rate risk and credit spread risk strategy, the institution shall evaluate the qualification and availability of employees necessary for the implementation thereof, and also the capabilities of the information system and organisational structure of the management to implement this strategy.

28. The institution shall establish and implement a risk culture in the areas of the management of interest rate risk and the assessment and supervision of credit spread risk in accordance with the requirements laid down in laws and regulations for the establishment of the internal control system.

29. The institution shall be obliged to achieve that the internal normative documents thereof in the area of the management of interest rate risk and also in the area of the assessment and supervision of credit spread risk ensure the implementation of the interest rate risk and credit spread risk strategy and determine authorities and regulations for the efficient identification, assessment, analysis, and monitoring of interest rate risk and also for the assessment and supervision of credit spread risk. The internal normative documents of the institution shall lay down requirements that are at least as cautious as the regulatory requirements.

30. The institution shall develop policies and procedures related to the management of interest rate risk which include at least the following:

30.1. the mutual separation of the non-trading book and trading book and the procedures for and supervision of internal risk transfer between books;

30.2. the definition of economic value used by the institution and conformity thereof to the method used for the valuation of asset and liability items;

30.3. the definition of net interest income used by the institution, additionally taking into account changes in the market value of instruments measured at fair value, and conformity thereof to the used approach to financial forecasting;

30.4. the cash flow modelling techniques used (conditional or unconditional cash flow modelling);

30.5. the assessment of fixed rate loan commitments, including the hedging of any related risk;

30.6. the sources of information necessary for the management of interest rate and the storage procedures thereof, and also the information technology systems used;

30.7. the approach to and methods for the assessment of interest rate risk;

30.8. the stress testing for interest rate risk, ranging from a simple sensitivity analysis to scenario analysis at different stress levels, namely from the baseline scenario which is based on the forecasts for operations of the institution, economic development, and business environment to a significant unfavourable scenario;

30.9. the aggregation of interest rate risk exposures in different currencies;

30.10. the procedures for managing, including identifying, assessing, analysing, and supervising, the basis risk, optionality risk, and spread risk;

30.11. the behavioural and modelling assumptions used in the assessment of interest rate risk in respect of both economic value and net interest income, additionally taking into account changes in the market value of instruments measured at fair value, at least for the following areas:

30.11.1. the level of detail used in calculations (for example, the use of time intervals or term groups, provided that the criteria for the allocation of cash flow remain consistent to ensure data comparability over different periods);

30.11.2. the balances of sight deposits, settlement accounts, savings accounts, and other liability items with short contractual residual maturity but long behavioural residual maturity, and also the interest flow from them;

30.11.3. the time deposits with an early withdrawal option;

30.11.4. the fixed interest rate loans, including with an early redemption option, and loan commitments;

30.11.5. the own funds items included in the calculation of economic value;

30.11.6. the use of optionality and interest rate options of the institution and customers (automatic and behavioural, embedded and direct) and the consequences of using the optionality, including stress testing at different stress levels, namely from the baseline scenario which is based on the forecasts for operations of the institution, economic development, and business environment to a significant unfavourable scenario;

30.11.7. the commercial reserves, including the definition and valuation methodology used by the institution;

30.11.8. the impact of accounting policy on the results of the assessment of interest rate risk, in particular the hedge-accounting effectiveness of interest rate risk;

30.11.9. the interest rate sensitive instruments linked to inflation or other market factors, justifying assumptions, for example, with reliable economic development forecasts or generally accepted market practices (for example, a future inflation forecast curve);

30.11.10. the diversification assumptions;

30.12. the methodology for determining the risk-free interest rate;

30.13. the process of identifying, assessing, allocating, and supervising the amount of capital necessary to cover interest rate risk, including the inclusion of interest-free assets and liabilities in the calculation;

30.14. the adequate limits that correspond to the institution’s willingness to take the interest rate risk of a specific level;

30.15. the procedures for supervising the interest rate risk hedging strategy (in respect of both economic value and net interest income, additionally taking into account changes in the market value of instruments measured at fair value), including that based on derivatives;

30.16. the procedures for controlling mark-to-market risk in respect of instruments carried at fair value;

30.17. the policies for validating models used in the assessment of interest rate risk and evaluating the relevant model risk;

30.18. the process of reporting and presenting accounts;

30.19. the duties, authorities, responsibility, and communication channels of employees involved in the management of interest rate risk.

31. The institution shall develop the policies and procedures related to the assessment and supervision of credit spread risk which include at least the following:

31.1. the mutual separation of the non-trading book and trading book and the procedures for and supervision of internal risk transfer between books;

31.2. the sources of information necessary for the assessment and supervision of credit spread risk and the storage procedures thereof, and also the information technology systems used;

31.3. the methodology for assessing credit spread risk which allows the institution to assess the credit spread risk of an individual exposure and the credit spread risk of a pool of exposures and the level of credit spread risk inherent to the overall operations of the institution in different periods in respect of both economic value and net interest income, additionally taking into account changes in the market value of instruments measured at fair value;

31.4. the stress testing for credit spread risk, ranging from a simple sensitivity analysis to scenario analysis at different stress levels, namely from the baseline scenario which is based on the forecasts for operations of the institution, economic development, and business environment to a significant unfavourable scenario;

31.5. the modelling assumptions used in the assessment of credit spread risk in respect of both economic value and net interest income, additionally taking into account changes in the market value of instruments measured at fair value;

31.6. the process of identifying, assessing, allocating, and supervising the amount of capital necessary to cover credit spread risk, taking into account the results of the analysis of the need to determine additional capital to cover credit spread risk;

31.7. the policies for validating models used in the assessment of credit spread risk and evaluating the relevant model risk;

31.8. the process of reporting and presenting accounts;

31.9. the duties, authorities, responsibility, and communication channels of employees involved in the assessment and supervision of credit spread risk.

32. The institution shall regularly, but at least once a year and under rapidly changing market conditions, test, validate, review, document, and approve the behavioural and modelling assumptions used in the assessment of interest rate risk and credit spread risk.

33. Prior to introducing a new financial service or entering a new market, the institution shall analyse the potential magnitude of interest rate risk and credit spread risk associated with these services, conformity thereof to the institution’s desired levels of interest rate risk and credit spread risk, and impact thereof on the amount of capital necessary to cover the institution’s interest rate risk and credit spread risk, and also the resources necessary for the management of interest rate risk and credit spread risk, including information technology systems and applications. The institution shall assess the need to develop new policies and procedures for the management of interest rate risk and credit spread risk of these financial services or to make amendments to the existing applicable policies and procedures. These requirements shall apply not only to the new financial services but also to the existing financial services the conditions of which change significantly.

34. The institution shall regularly, but at least once a year, review the internal normative documents regarding the management of interest rate risk and the assessment and supervision of credit spread risk on the basis of the results of the management of interest rate risk and the assessment and supervision of credit spread risk in order to ensure conformity thereof to the institution’s business model, operational strategy, macroeconomic situation, and future forecasts and also best international practices.

35. The institution shall lay down the internal reporting procedures for deviations from the approved internal normative documents.

36. The institution shall establish, document, and strictly follow clearly defined limits that ensure implementation of the interest rate risk policy of the institution in accordance with the interest rate risk strategy and the willingness to take the risk and that are applicable when assessing the impact of the planned exposure on the interest rate risk of the institution.

37. When introducing the interest rate risk limit system, the institution shall ensure compliance with the following requirements:

37.1. develop limits at the individual level and at the level of the prudential consolidation group or on a sub-consolidated basis within the meaning of Regulation No 575/2013 according to the institution’s size, business model, operational objectives, nature, and complexity, capital adequacy, the amount of current and planned transactions, and also the ability of the institution to manage interest rate risk;

37.2. in accordance with Sub-paragraph 37.1 of this Regulation, set limits for each component of interest rate risk or individual unit, portfolio, products, type of instruments, specific instrument;

37.3. determine and, if necessary, improve limits of interest rate risk, taking into account historical fluctuations of interest rate, stress testing scenarios and results at different stress levels, namely from the baseline scenario which is based on the forecasts for operations of the institution, economic development, and business environment to a significant unfavourable scenario;

37.4. regularly, but at least once a year, review and, if necessary, improve limits of interest rate risk according to changes in the operations of the institution and the external and internal conditions affecting the operations of the institution.

38. The institution shall establish procedures for providing timely information to the management of a relevant level and also the actions and responsibility in the case of non-compliance or potential non-compliance with the limits of interest rate risk. If policies of the institution provide for a possibility to deviate from the set limits in extraordinary cases, such deviation shall be approved by the executive board or a committee authorised for this purpose.

**3. Responsibility of the Institution’s Management in the Area of the Management of Interest Rate Risk and the Assessment and Supervision of Credit Spread Risk**

39. The supervisory board of the institution shall:

39.1. approve the interest rate risk and credit spread risk strategy;

39.2. approve the major policies for the implementation of the interest rate risk strategy and the credit spread risk strategy, including the procedure for delegating responsibility and duties in the area of the management of interest rate risk and the assessment and supervision of credit spread risk;

39.3. lay down the procedures for exchanging information between the supervisory board and the executive board, ensuring that the executive board of the institution submits a report to the supervisory board of the institution on the management of interest rate risk and the assessment and supervision of credit spread risk, aggregating information on the achievement of the objectives set in the interest rate risk and credit spread risk strategy, reporting on the results of limit control and stress testing, and, if necessary, submitting an action plan for overcoming critical situations;

39.4. monitor and control how the executive board of the institution manages the interest rate risk and credit spread risk inherent to the operations of the institution and whether this activity is performed in accordance with the interest rate risk and credit spread risk strategy and policies;

39.5. ensure that the remuneration policy of the institution is not in conflict with the interest rate risk and credit spread risk strategy thereof and does not promote short-term profit-making that poses a threat to the medium- and long-term objectives when conducting transactions exposed to the interest rate risk and credit spread risk;

39.6. ensure that the institution allocates sufficient resources, including employees with an appropriate qualification, for the management of interest rate risk and the assessment and supervision of credit spread risk;

39.7. regularly, but at least once a year, on the basis of the institution’s financial results and operational plans, the results of the management of interest rate risk and the assessment and supervision of credit spread risk and taking into account changes in laws and regulations, economic situation, markets, and forecasts, and also the introduction of new financial services, review the interest rate risk and credit spread risk strategy and major policies and assess the capital adequacy necessary to cover the interest rate risk and credit spread risk that it has taken or will take.

40. The executive board of the institution shall be responsible for the implementation of the interest rate risk and credit spread risk strategy approved by the supervisory board of the institution and also for the efficient management of interest rate risk and the assessment and supervision of credit spread risk, and it shall:

40.1. ensure the development of policies and procedures for the management of interest rate risk;

40.2. ensure the development of policies and procedures for the assessment and supervision of credit spread risk;

40.3. ensure the achievement of the objectives set in the interest rate risk strategy of the institution and the application of policies and procedures for the management of interest rate risk in order to provide reasonable assurance of achieving the objectives of the management of interest rate risk;

40.4. ensure the achievement of the objectives set in the credit spread risk strategy of the institution and the application of policies and procedures for the assessment and supervision of credit spread risk in order to provide reasonable assurance of achieving the objectives of the assessment and supervision of credit spread risk;

40.5. determines the distribution of authorities, duties, and responsibility for the management of interest rate risk and the assessment and supervision of credit spread risk among the institution’s units and responsible employees, following the principle that the functions of the management of interest rate risk and the assessment and supervision of credit spread risk should be independent from the functions of taking the interest rate risk and credit spread risk;

40.6. approve the limits for the management of interest rate risk, including the procedures for deviating from the limits set, and ensure compliance with and regular review thereof;

40.7. approve the initiatives to hedge the interest rate risk and credit spread risk prior to the implementation thereof;

40.8. approve and regularly review the stress testing procedures, scenarios, assumptions, and the procedures for submitting reports on stress testing results of the management of interest rate risk and the assessment and supervision of credit spread risk, determining the unit or employees responsible for timely preparation and submission of reports to the executive board, and ensure control;

40.9. ensure the validation of the methods used in the management of interest rate risk and the assessment and supervision of credit spread risk and the evaluation of the relevant model risk;

40.10. regularly, but at least once every calendar quarter, examine and evaluate the results of the management of interest rate risk and the assessment and supervision of credit spread risk, determining the procedures and frequency for submitting reports on the results of the management of interest rate risk and the assessment and supervision of credit spread risk;

40.11. ensure that the employees involved in the management of interest rate risk and the assessment and supervision of credit spread risk are informed about the interest rate risk and credit spread risk strategy, policies, and procedures, and responsibility for the compliance with the policies and procedures of the institution;

40.12. ensure the attraction of such employees whose qualification, technical knowledge, and experience correspond to the duties to be performed in the management of interest rate risk and the assessment and supervision of credit spread risk.

41. The institution’s performer of the internal audit function or performer of the external audit shall regularly audit the process of managing the interest rate risk and assessing and controlling the credit spread risk and assess the effectiveness thereof, and ascertain that the practice of the institution in the management of interest rate risk and credit spread risk complies with the internal normative documents of the institution and that employees of the institution also adhere to the internal normative documents introduced. Additionally, the performer of the internal audit function or performer of the external audit shall regularly audit the information systems, including data quality. Reports on the results of the audits carried out and the deficiencies detected shall be submitted to the supervisory board of the institution. The institution shall, within one month after submission of the internal or external audit report to the supervisory board of the institution, submit a copy of this report to Latvijas Banka, an excerpt of the minutes of the relevant meeting of the supervisory board, and information on the decisions taken by the supervisory board regarding the measures to be taken by the institution in order to implement the audit recommendations, including to eliminate the deficiencies and shortcomings detected during the audits.

**4. Management Information System**

42. The institution shall introduce a management information system which provides such information that enables the management of the institution to duly supervise the system for the management of interest rate risk and the assessment and supervision of credit spread risk, including the maintenance of the capital necessary to cover interest rate risk and credit spread risk and examine results of the stress testing, and it shall:

42.1. ensure timely, high-quality (reliable, accurate, traceable), detailed, and comprehensive information on transactions exposed to the interest rate risk and credit spread risk;

42.2. ensure that all components of the interest rate risk are identified and the interest rate risk is supervised at any portfolio, unit, subsidiary, individual, prudential consolidation group level, or on a sub-consolidated basis within the meaning of Regulation No 575/2013;

42.3. enable to assess, including in terms of currency, both the total extent of the interest rate risk and credit spread risk of the institution and the extent of the interest rate risk and credit spread risk in different portfolios (in particular portfolios that can be potentially subject to significant changes in the market value) or transactions;

42.4. enable to assess sensitivity of the institution to changes in market conditions and other significant factors;

42.5. enable to assess the conformity of the extent of interest rate risk and credit spread risk to the objectives and limits set in the interest rate risk and credit spread risk strategy and policies.

43. The institution shall regularly, but at least once every calendar quarter and each time when the institution receives information indicating a deterioration in the interest rate risk and credit spread risk profile, prepare reports on interest rate risk and credit spread risk for the institution’s management of the relevant level which shall examine them and take appropriate decisions in a timely manner.

44. The institution shall adjust the level of detail of the interest rate risk and credit spread risk report to the relevant management level and also to the specific situation and business environment of the institution.

45. The interest rate risk report shall include at least the following:

45.1. a summary of the institution’s total extent of interest rate risk, changes thereof, and the factors affecting the changes (for example, assets, liabilities, cash flows, and strategies);

45.2. information on spread risk, basis risk, and optionality risk transactions;

45.3. information on non-trading book transactions which can be exposed to significant changes in the market value and the impact of the respective changes;

45.4. a summary of business environment conditions and changes in other significant factors of the interest rate risk;

45.5. information attesting conformity of the operations of the institution to the interest rate risk strategy and policies;

45.6. information on compliance with the limits and positions where the set limits could be exceeded;

45.7. a comparison of the previous forecasts or interest rate risk estimates with the actual results (for example, a comparison of the forecasted loss resulting from early redemption of the fixed interest rate loans with the historically realised loss) to identify potential modelling deficiencies;

45.8. detailed information on behavioural and modelling assumptions, impact thereof on the amount of interest rate risk, including economic value, net interest income, additionally taking into account changes in the market value of instruments measured at fair value, and information on changes in assumptions in the stress tests of interest rate risk;

45.9. detailed information on the impact of the interest rate derivatives used on the amount of interest rate risk, including economic value and net interest income, additionally taking into account changes in the market value of instruments measured at fair value;

45.10. detailed information on the impact of instruments measured at fair value, including Tier 3 assets and liabilities within the meaning of Commission Regulation (EC) No 1126/2008 of 3 November 2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council, on the amount of interest rate risk and also economic value and net interest income, additionally taking into account changes in the market value of instruments measured at fair value;

45.11. information on the scenarios and assumptions used in stress testing, including supervisory outlier tests, results of the stress testing, and sensitivity thereof in respect of the major assumptions, conclusions made, and decisions taken;

45.12. a summary of the review of the process of managing interest rate risk and the audits carried out on the process of managing interest rate risk by the performer of the internal audit function or the performer of the external audit, and the main conclusions made as a result of the audits carried out.

46. The credit spread risk report shall include at least the following:

46.1. a summary of the institution’s total extent of credit spread risk, changes thereof, and the factors affecting the changes (for example, assets, liabilities, cash flows, off-balance sheet position, strategies);

46.2. information on non-trading book transactions which can be exposed to significant changes in the market value, and impact of the respective changes;

46.3. a summary of business environment conditions and changes in other significant factors of the credit spread risk;

46.4. information attesting conformity of the operations of the institution to the credit spread risk strategy and policies;

46.5. information on modelling assumptions;

46.6. a comparison of the previous forecasts or credit spread risk estimates with the actual results to identify potential modelling deficiencies;

46.7. information on the scenarios and assumptions used in stress testing, stress testing results, conclusions made, and decisions taken;

46.8. a summary of the review of the process of assessing and supervising credit spread risk and the audits carried out on the process of assessing and supervising credit spread risk by the performer of the internal audit function or the performer of the external audit, and the main conclusions made as a result of the audits carried out.

47. The institution shall establish and appropriately document a transparent communication and reporting mechanism to provide the management, units, and employees of the institution with a possibility of receiving and exchanging information on the management of interest rate risk and the assessment and supervision of credit spread risk, including changes in the levels of interest rate risk and credit spread risk.

48. The institution shall, as far as possible, use the same data, assumptions, definitions, and processes in the management of interest rate risk that it uses in the valuation and planning of financial statement items thereof, including budgeting, individually and at the level of the prudential consolidation group, or on a sub-consolidated basis within the meaning of Regulation No 575/2013.

49. Prior to using any external or internal data for the management of interest rate risk and the assessment and supervision of credit spread risk, including establishing a historical database, the institution shall perform appropriate data quality checks and assure the accuracy, reliability, and conformity of the data for intended use. Additionally, the institution shall:

49.1. document the source data used in the management of interest rate risk and the assessment and supervision of credit spread risk;

49.2. determine the frequency of updating the historical database used in the management of interest rate risk and the assessment and supervision of credit spread risk.

50. The institution shall, within the framework of the information technology system thereof, ensure the integrity, current relevance, reliability, and accuracy of the information and data used in the management of interest rate risk and the assessment and supervision of credit spread risk, including in the case of a crisis. The institution shall develop and implement control procedures for the management of any non-compliance and violations arising during data processing, including the identification, processing, and rectification of the causes of non-compliance and violations.

51. The institution shall provide the necessary information technology systems and applications for the management of interest rate risk and the assessment and supervision of credit spread risk in order to ensure timely, accurate, and complete assessment and supervision of interest rate risk and credit spread risk, processing of characterising information and exposures, and evaluation of results, and also preparation of reports.

52. The institution shall ensure that the information technology systems and applications are appropriate and flexible in respect of the amount, diversity, and complexity of the operations carried out (for example, such that are capable of applying stress tests for interest rate risk and credit spread risk at different stress levels and, if necessary, capable of applying also additional scenarios, and also calculating relevant indicators, such that are capable of calculating net interest income, economic value, economic value of own funds, and changes in the market value of instruments in the non-trading book measured at fair value, and imposing specific limits on the internal risk parameter assumptions of the institution) where complete and regularly updated information is available on the following:

52.1. each exposure exposed to the interest rate risk and credit spread risk, including on each exposure exposed to the spread risk, basis risk, and optionality risk;

52.2. the repricing date of each transaction, the type and size of interest rate, the size of credit spread, options (for example, early redemption, early withdrawal), and payments related to the implementation of the respective options.

53. The institution shall provide users of the information technology system, according to the level of authority thereof, with a possibility to:

53.1. summarise information on exposures exposed to the interest rate risk and credit spread risk by financial services, individual parts of financial services, portfolios, specific characteristics;

53.2. assess the impact of individual exposures on the total amount of exposures;

53.3. assess the impact of an individual exposure, portfolio, or product on the total levels of interest rate risk and credit spread risk.

54. When implementing the information technology systems for the management of interest rate risk and the assessment and supervision of credit spread risk, the institution shall ensure that the security of the development and implementation process, including the security of the information and data to be used, conforms to the requirements laid down in laws and regulations in the field of information systems security.

55. The institution shall ensure that plans for the continuity of operations and recovery of operations in extraordinary cases for the information technology systems used in the management of interest rate risk and the assessment and supervision of credit spread risk are tested within the framework of common regular testing of information systems of the institution.

**5. Assessment of Interest Rate Risk**

56. The institution shall assess interest rate risk in accordance with one of the following approaches:

56.1. the standardised methodology referred to in the directly applicable legal act of the European Union;

56.2. the simplified standardised methodology referred to in the directly applicable legal act of the European Union if the institution has been identified as a small and non-complex institution within the meaning of Article 4(1)(145) of Regulation No 575/2013;

56.3. the internal system which conforms to the requirements laid down in Chapter 5 of this Regulation.

57. The institution shall ensure that the assessment of interest rate risk covers all components and sources of interest rate risk.

58. The institution shall not rely in the assessment of interest rate risk solely on the supervisory stress test specified in the directly applicable legal act of the European Union and also not on the results of the assessment of interest rate risk conducted by Latvijas Banka or other supervisory authorities and shall not use them as the sole method for the assessment of interest rate risk. However, the institution shall ensure that the supervisory stress tests specified in the directly applicable legal act of the European Union are integrated into the institution’s management of interest rate risk as an integral part thereof and are used as additional tools in the assessment of interest rate risk.

59. The institution shall apply to the assessment of interest rate risk several analytical and statistical methods corresponding to the operational strategy, business model, specific nature and complexity of the operations thereof, allowing the institution to assess the interest rate risk of individual exposures and portfolios thereof, and also the overall level of interest rate risk level inherent to the operations of the institution in different periods of time, namely short-term and long-term, in respect of economic value and net interest income, additionally taking into account changes in the market value of instruments measured at fair value, for example:

59.1. the gap analysis, including the repricing gap method and the full revaluation approach, parallel gap analysis, and non-parallel gap analysis;

59.2. the duration analysis, including the calculation of the modified duration and partially modified duration;

59.3. convexity analysis;

59.4. the grouping of interest rate sensitive instruments by different interest rates or options.

60. The institution may use the methods for the assessment of interest rate risk specified in Annexes I and II to the European Banking Authority’s Guidelines EBA/GL/2022/14 of 20 October 2022, Guidelines issued on the basis of Article 84 (6) of Directive 2013/36/EU specifying criteria for the identification, evaluation, management and mitigation of the risks arising from potential changes in interest rates and of the assessment and monitoring of credit spread risk, of institutions’ non-trading book activities.

61. The institution shall document and regularly review the selection, nature, limitations, and application procedures of the methods employed, and also the assumptions and estimates used in the methods. The institution may not rely on a single method when assessing the interest rate risk. The institution shall ensure that the quantitative measurement of interest rate risk corresponds to the specific nature, complexity, current and planned amount of transactions, and diversity of the operations of the institution to assess all sources of interest rate risk inherent to the institution, such as:

61.1. mismatched maturities for attracting and placing interest rate sensitive instruments;

61.2. mismatched maturities for reviewing interest rates for interest rate sensitive instruments in assets and liabilities;

61.3. the concentration of interest rate sensitive instruments over different time intervals;

61.4. the use of derivatives and other interest rate risk hedging instruments from the perspective of different base assets, convexity, and maturity;

61.5. transactions involving early withdrawal or early redemption options;

61.6. the use of interest rate swaps and interest rate options;

61.7. other sources of interest rate risk.

62. The institution shall include commercial reserves in the calculation of changes in net interest income. When taking the decision to exclude commercial reserves and other gaps from the calculation of changes in economic value, the institution shall ensure that:

62.1. a transparent methodology is used to determine the risk-free interest rate at the moment when each instrument is incurred;

62.2. the exclusion of commercial reserves from the cash flow is justified and corresponds to the management and hedging of interest rate risk of the institution;

62.3. the approach used is consistently applied to all units of the institution and all interest rate sensitive instruments.

63. When determining the behavioural and modelling assumptions to be used in the assessment of interest rate risk, the institution shall take into account the materiality thresholds specified in the directly applicable legal act of the European Union that determines the standardised methodology and the simplified standardised methodology.

**5.1. Assumptions about the Behaviour of Customers in Respect of Accounts with an Embedded Customer Option**

64. The institution shall develop and document in the internal normative documents a policy governing the determination and regular assessment of the assumption in respect of the balance sheet and off-balance sheet items with an embedded option, including:

64.1. identify all significant products and positions with an embedded option that could affect the applied interest or repricing date;

64.2. establish strategies for pricing and mitigation of interest rate risk (for example, use of derivatives, imposition of a fine for early termination of a time deposit or loan contract) in order to manage options of the behaviour of customers within the desired level of interest rate risk;

64.3. ensure that the modelling of assumptions about the behaviour of customers is based on prudent assumptions, justified by historical data and back-testing;

64.4. assess the impact of the assumptions to be used on the results of the assessment of interest rate risk, including conduct stress testing of the assumptions and ascribing the results to the amount of capital necessary to cover interest rate risk;

64.5. ensure the validation of the assumptions to be used in order to verify stability thereof in the course of time and adjust it, where necessary.

65. When analysing the impact of behavioural and modelling assumptions to be used on the results of the assessment of interest rate risk, the institution shall take into account the following:

65.1. the movement of the balance of customer funds between different types of products, as characteristics, conditions, and terms thereof change;

65.2. the ability of product rates to adjust to changes in market interest rates;

65.3. the potential impact on the rate of early redemption of the current and future loans which is caused by the economic environment, terms of the contract, scenarios for changes in interest rates, and other values affecting the embedded behavioural options.

66. When determining and documenting in the internal normative documents the assumptions about the behaviour of customers in respect of accounts without fixed repricing dates or accounts with an unspecified maturity, the institution shall:

66.1. ensure that sight deposits accepted from financial customers within the meaning of Article 411 of Regulation No 575/2013 are not subject to the behavioural modelling, except for the operational deposits specified in Article 27(1)(a) of Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions;

66.2. ensure that the assumptions reflect characteristics of accounts held by both depositors (small or medium enterprises, private individuals, or corporate depositors) and customers in at least three categories:

66.2.1. the sight deposits of private individuals, small or medium-sized enterprises within the meaning of Article 411 of Regulation No 575/2013 that are held in the account for transactions, including interest-free sight deposits and other balances in accounts the compensation component of which does not affect the decision of the customer to hold funds;

66.2.2. the sight deposits of private individuals, small or medium-sized enterprises, except for the deposits referred to in Sub-paragraph 66.2.1 of this Regulation, the compensation account of which affects the decision of the customer to hold funds in the account;

66.2.3. the corporate deposits, except for those of financial customers within the meaning of Article 411 of Regulation No 575/2013 or other fully price sensitive accounts;

66.3. determine a stable amount of sight deposits for each of the categories referred to in Sub-paragraph 66.2 of this Regulation, using observed changes in the amount of sight deposits that are related to the top-down and bottom-up movements of risk-free interest rate at least over the previous 10 years;

66.4. identify the base of basic funds for each of the categories referred to in Sub-paragraph 66.2 of this Regulation, namely stable sight deposits the repricing of which is unlikely in a significantly changing environment of interest rate and market conditions, and also identify sight deposits with limited flexibility against changes in interest rates;

66.5. assess the potential movement of the balance of customer funds between sight deposits and other deposits which can change the behavioural assumptions in different scenarios for changes in interest rates;

66.6. except for the deposits referred to in point 2(a) of Article 428f of Regulation No 575/2013, but not limited to centrally regulated deposits and deposits with significant economic or fiscal restrictions in the case of withdrawal, present a repricing maturity that does not exceed the weighted average maximum repricing maturity of five years in respect of the following categories of deposits:

66.6.1. the operational deposits specified in Article 27(1)(a) of Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions;

66.6.2. the sight deposits of private individuals, small or medium-sized enterprises;

66.6.3. the corporate sight deposits attracted from customers other than financial customers within the meaning of Article 411 of Regulation No 575/2013;

66.7. apply the five-year restriction referred to in Sub-paragraph 66.6 of this Regulation both to the amount of the total portfolio of all the categories of deposits referred to in Sub-paragraphs 66.6.1, 66.6.2, and 66.6.3 of this Regulation and each currency separately;

66.8. assess the potential restrictions on the repricing of deposits of private individuals and small or medium-sized enterprises in an environment of low or negative interest rates and the impact of such restrictions on the stability of deposits in different scenarios for changes in interest rates;

66.9. ensure that assumptions about the base of basic funds of customers and the reduction of other modelled balances are prudent, justified, and appropriate, balancing the benefits from net interest income with the additional risk of economic value that is related to fixing the future interest rate return on the assets financed by such funds and the potential loss of revenue under circumstances of a rising interest rate;

66.10. not rely solely on one analytical or statistical method for determining behavioural assumptions, repricing dates, and cash flow profile of sight deposits, and supplement the quantitative assessment with an expert qualitative evaluation;

66.11. assess the impact of the assumptions to be used on the results of the assessment of interest rate risk (economic value and net interest income, additionally taking into account changes in the market value of instruments measured at fair value) and the amount of capital necessary to cover interest rate risk, including conduct a sensitivity analysis in respect of the assumption parameters (for example, the amount of the basic funds of customers and repricing date) and calculations according to the terms of the contract in order to exclude the impact of assumptions.

**5.2. Assumptions about the Own Funds Items**

67. When determining and documenting in the internal normative documents the assumptions about investment maturity, namely the assumptions about the stabilisation of income generated from the use of own funds, the institution shall:

67.1. establish a methodology to identify which own funds items are considered to be suitable for such an assumption;

67.2. determine the investment maturity profile for the appropriate own funds that balances the benefit from the stabilisation of income arising from investing funds in long-term positions with fixed returns against the additional sensitivity of the economic value of the respective positions under conditions of interest rate stress, and the risk of insufficient generation of income as interest rates rise;

67.3. assess the impact of the chosen investment maturity profile on the results of the assessment of interest rate risk (economic value and net interest income, additionally taking into account changes in the market value of instruments measured at fair value), including regularly make calculations, excluding the own funds items.

68. When taking the decision to use the assumption about the investment maturity in respect of the own funds items, the institution shall take into account that it may not invest in the positions that significantly restrict its ability to adapt to the changing economic and business environment.

69. If the institution has not determined the assumptions about the investment maturity in respect of the own funds items or has determined assumptions of a short-term nature, the institution shall assess and document the impact of the selected approach on the volatility of economic value and net interest income.

70. Assumptions about the investment maturity shall be considered elements of the institution’s planning cycle, and they may not be adjusted to changes in the forecasts for the volatility of the institution’s interest rates.

**5.3. Stress Testing for the Interest Rate Risk, Assessment of Critical Situations, and Measures to Prevent or Eliminate Them**

71. For the purpose of identifying how the potential changes in interest rates affect the interest rate sensitive instruments, the economic value of the institution, the economic value of own funds, and net interest income, additionally taking into account changes in the market value of instruments measured at fair value, the availability of the capital necessary to cover potential loss or other resources, and the prices thereof for overcoming critical situations, the institution shall regularly, but at least once every calendar quarter, and each time when the institution receives information indicating a deterioration in the interest rate risk profile (including increased volatility of interest rates), perform stress testing which includes at least the following:

71.1. the stress tests developed by the institution in accordance with the requirements laid down in Paragraphs 74, 75, 76, 77, 78, 79, 80, 81, 82, 83, 84, 85, and 86 of this Regulation;

71.2. the supervisory stress tests referred to in the directly applicable legal acts of the European Union.

72. Additionally, the institution shall regularly, but at least once a year, assess the critical stress tests within the process of assessing the capital adequacy, including assess its ability to overcome the critical situation identified and analyse the feasibility of the intended action plan.

73. The institution shall also ensure stress testing in accordance with the stress test, including scenario and assumptions, specified by Latvijas Banka, if so required.

74. The institution shall use forward-looking stress tests in stress testing with a sufficiently significant impact on the institution, but not such that are impossible. The quantity and level of detail of the stress tests shall depend on the institution’s size, specific nature of operations and objectives, the amount, diversity, and complexity of the current and planned transactions, and also on the risk profile of the institution.

75. The institution shall develop and document the objectives and methodology of stress testing, stress scenarios, parameters, and assumptions that are statistically and economically justified and, after approval thereof by the executive board, shall perform stress testing for the interest rate risk, analyse results of the stress testing, and use them in the management of interest rate risk and decision-taking, including taking decisions on the amount of capital necessary to cover the potential loss, improvement of the limit system, review of the interest rate risk strategy and the internal normative documents.

76. When developing stress tests, the institution shall take into account all available internal and external information on historical fluctuations of interest rates and current conditions and behaviour, and also future forecasts and interest rate simulations.

77. For the purpose of ensuring high-quality stress testing for interest rate risk, the institution shall, using sensitivity analysis and scenario analysis at the institutional level and level of the prudential consolidation group within the meaning of Regulation No 575/2013, develop such stress tests that include changes in quantitative and qualitative components of interest rate risk and the indicators affecting them, including changes in the indicators characterising current and future conditions of the business environment for different periods and stress levels, namely from the baseline scenario which is based on the forecasts for operations of the institution, economic development, and business environment to a significant unfavourable scenario which is based on significant unfavourable forecasts for economic development.

78. When analysing the indicators characterising current and future conditions of the business environment and changes thereof, the institution shall use the indicators characterising the macroeconomic situation and development thereof, the competitive environment and development thereof, and also the indicators characterising general market trends.

79. When performing stress testing, the institution shall calculate and analyse the correlation of interest rate risk with other risks, in particular market risk, liquidity risk, and credit risk, and also calculate the secondary impact.

80. The institution shall analyse both the potential impact of a one-time event and the consequences that might be caused by events over a longer period, including in relation to potential changes in customer behaviour.

81. When developing the methodology for the stress testing for interest rate risk and performing stress testing, the institution shall ensure the following:

81.1. stress tests for changes in different interest rates, including in the slope and shape of the yield curve (parallel and non-parallel changes);

81.2. stress tests for changes in assumptions about the correlation of changes in interest rates and own funds items and also about the behaviour of asset and liability items, including stress tests where the assumptions (for example, behavioural assumptions) themselves are functions of changes in the level of interest rates;

81.3. the use of assumptions about conditional or unconditional cash flow modelling approaches;

81.4. proper assessment of the justification of diversification assumptions;

81.5. stress tests reflecting significant changes in the interrelationship of key market rates to assess the basis risk;

81.6. scenarios for stress testing for negative interest rates and provide for a possibility that negative interest rates can asymmetrically affect interest rate sensitive instruments;

81.7. reverse stress testing in order to:

81.7.1. identify such negative consequences which can significantly threaten the institution’s capital, economic value, financial indicators, and net interest income, additionally taking into account changes in the market value of instruments measured at fair value;

81.7.2. recognise events or combinations of events that could result in the negative consequences referred to in Sub-paragraph 81.7.1 of this Regulation;

81.7.3. identify deficiencies in the interest rate risk hedging strategies;

81.7.4. determine the necessary corrective measures;

81.8. special stress tests that are characteristic of the business model and operating profile of the institution.

82. The institution shall perform stress testing for interest rate risk separately for each currency in which it has interest rate sensitive instruments and also at an aggregate level, determining and documenting the method for aggregating different currencies. As regards significant currencies in which the institution has conducted transactions, the institution shall apply the stress tests that are characteristic of the currency and aligned with economic characteristics. All asset or liability positions of the non-trading book in a foreign currency shall be revalued and disclosed by the institution in euros according to the foreign exchange rate used in accounting as at the reporting date.

83. If the institution uses the assumption about interrelationships between interest rates of different currencies when performing stress testing for interest rate risk, it shall analyse the impact of this assumption on the total results.

84. When performing stress testing with sensitivity analysis in respect of economic value, the institution shall evaluate the limitations related to the use of the assumption about the run-off balance sheet and the ability of the institution to cover long-term interest rate risk.

85. In cases where balance sheet instruments are characterised by significant revaluation limitations (upper or lower limits), the institution shall, if it is relevant, take into account the impact that would occur by replacing the respective instruments with other instruments that have comparable characteristics, irrespective of the use of the assumption about the run-off balance sheet.

**6. Validation of Models**

86. The institution shall regularly, but at least once a year, perform the validation of the models used in the assessment of interest rate risk and credit spread risk and assess the corresponding model risk that is clearly defined in the internal normative documents of the institution.

87. The institution shall ensure that the validation of models and the assessment of the model risk are performed by the employees who have the necessary qualification, knowledge, and experience in the performance of such task and who have not been involved in the development of the model.

88. The institution shall ensure that the review and validation of the model input data, modelling methodology, underlying assumptions, and model outputs are independent of the development of the model.

89. The institution shall perform the initial validation of the model for the assessment of interest rate risk and credit spread risk prior to using the model and performing the ongoing validation.

90. The institution shall ensure a clear division of duties and responsibility to develop models and perform high-quality and independent initial and ongoing validation of models, and also to ensure appropriate documentation of the validation of models. The institution shall document the calculations for the review and validation of models in such a detailed manner that a third party can re-perform the respective analysis and calculations.

91. The validation policy, including the validation of mathematical calculations, assumptions, and software of the models used in the assessment of interest rate risk and credit spread risk, irrespective of whether internal or external input data and models are used, shall include at least the following:

91.1. information on the procedures for the initial and ongoing validations, including the verification of processes and determination of benchmarks, processes, methods, and tools used in the validation, and objectives thereof to ensure the integrity of model and identify the circumstances in which the underlying assumptions of the model are inadequate and the input variables do not form reasonable and efficient grounds for the modelling result;

91.2. information on the frequency of validation and the circumstances that determine the need for additional validation;

91.3. duties, authorities, and responsibility of the employees involved in the development of the initial and ongoing validation process, evaluation and approval of results, and decision-taking;

91.4. procedures for evaluating the conceptual and methodological justification of the model and also the justification of the model risk which is based on quantitative and qualitative criteria;

91.5. analysis of the internal and external input data, modelling methodology, underlying assumptions of the model, and results provided by the model, including comparison of the results obtained from the model calculation with the actual results;

91.6. procedures for evaluating the process of using expert opinions and judgements;

91.7. validation of diversification assumptions;

91.8. procedures to follow in the case where problems have been identified in the validation process in respect of the reliability of the model and the decision-taking process to resolve these problems;

91.9. transition policy for the amendment or withdrawal of the approved models, including procedures for controlling and documenting changes and versions.

92. The institution shall ensure that, during the process of reviewing and validating models, a validation report is prepared, documenting results of the validation and also conclusions and consequences arising from the analysis of validation, and recommendations for the review and further use of model specifications. The validation report shall be submitted to the institution’s management of the relevant level which has sufficient authority to take the decision to eliminate deficiencies of models and approve the use of models.

93. After the approval of models, the institution shall ensure a cycle of the ongoing validation of models which includes supervision, review of the models and comparing of the modelling results with the actual results.

94. The institution shall ensure a process of ongoing reviewing of the models where:

94.1. criteria and conditions are defined to determine whether increased attention is required for the review results or part thereof;

94.2. procedures for informing the management in a timely manner are laid down in the case of increased attention to take the decision on measures to eliminate deficiencies of the model, limitations on the use of the model, and, if necessary, other measures.

95. Taking into account the nature of the external data and models, the institution may integrate the external model into the internal model to manage and control the interest rate risk and credit spread risk, ensuring adequate adaptation of the external data and models to the institution’s size, specific nature of operations, and the amount of the conducted and planned transactions.

96. The institution shall ensure that all employees involved in the use of the external model have a sufficiently detailed understanding of the components of the external model, including analysis, assumptions, methodologies, and technical and operational aspects related to the components of the external model, and that the external models are appropriately integrated into the overall risk management systems and processes of the institution.

97. The institution shall regularly review the justification for the selection of a specific external model or set of external data thereof and also continuously evaluate updates of the external data and the external model. The institution shall document the justification for the selection and use of external data and external models from the perspective of the specific nature of operations and risk profile of the institution, including in the justification information at least on the following:

97.1. the integration of the external models into the processes and internal model of the institution;

97.2. the external data used in the internal model, and also sources and use thereof;

97.3. the aspects of the external data and external models relevant to the risk profile of the institution, including limitations.

**7. Criteria and Procedures for Determining that the Internal Systems Implemented by the Institution for the Assessment of Interest Rate Risk are Unsatisfactory**

98. When evaluating the quality of the institution’s management of interest rate risk, including the methodology for the assessment of interest rate risk, Latvijas Banka shall rely on the analysis of the information and reports provided by the institution and take into account at least whether:

98.1. the system for the assessment of interest rate risk is efficient and ensures timely identification, supervision of the deterioration of the level of interest rate risk and taking of necessary measures in a timely manner;

98.2. the institution properly analyses all significant factors and sources of interest rate risk that affect the level of interest rate risk at the moment of the assessment;

98.3. the management of the institution is regularly informed of the level of interest rate risk, the results of stress testing, and the amount of capital necessary to cover interest rate risk;

98.4. the assumptions, estimates, and conclusions of the institution are reasonable, appropriately justified, and documented;

98.5. the policies, procedures, and practices of the institution conform to the requirements of this Regulation.

99. The internal system established by the institution for the assessment of interest rate risk shall be considered unsatisfactory within the meaning of Section 49.2 of the Credit Institution Law in any of the following cases:

99.1. it does not conform to the requirements of this Regulation, taking into account the principle of proportionality specified in Paragraph 5 of this Regulation;

99.2. the implemented methods for the assessment of interest rate risk do not cover economic value and net interest income, additionally taking into account changes in the market value of instruments measured at fair value, all components of interest rate risk, or all interest rate sensitive instruments in a reasonable manner. For the purpose of ensuring proper assessment of the extent of interest rate risk, the institution may not be limited to the methods referred to in Paragraphs 59 and 60 of this Regulation;

99.3. it has not been regularly calibrated, back-tested, and all parameters and assumptions have not been reviewed, including calibration, testing, and review have not been properly supervised and documented, taking into account the nature, size, complexity, and diversity of interest rate risk in the business model and types of operations of the institution.

**8. Assessment and Supervision of Credit Spread Risk**

100. The institution shall ensure the assessment and supervision of credit spread risk that cover all sources of credit spread risk, including changes in the market credit spread and market liquidity spread, and that allow to assess and supervise both how changes in credit spread risk affect the economic value and net interest income of the institution, additionally taking into account changes in the market value of instruments measured at fair value, and mutual interaction thereof in the short and long term. The institution may include in the assessment and supervision of credit spread risk the idiosyncratic credit spread, reflecting a specific credit risk which is associated with the credit quality of an individual borrower (also reflecting the assessment of risks arising from the sector and geographic location of the borrower) and the specific nature of the credit instrument (for example, whether it is a debt instrument or derivative) if inclusion thereof ensures more conservative results of the assessment of credit spread risk.

101. When assessing changes in the market credit spread and market liquidity spread, the institution may consider aspects, which are specific to a particular currency, as a significant criterion for the assessment of market credit spread and market liquidity spread.

102. In the assessment and supervision of credit spread risk, the institution shall avoid any overlap with the system for the management of credit value adjustment risk within the meaning of Regulation No 575/2013.

103. The institution shall take into account the impact of accounting policy on the results of the assessment and supervision of credit spread risk, in particular on net interest income, additionally taking into account changes in the market value of instruments measured at fair value.

104. The institution shall establish and implement a system for the supervision of credit spread risk that ensures at least the following:

104.1. efficient preparation and supervision of documentation;

104.2. assessment and supervision of the impact of modelling assumptions to be used on the results of the assessment of credit spread risk (including economic value, net interest income, and changes in the market value of instruments in the non-trading book measured at fair value);

104.3. assessment and supervision of credit spread risk for derivatives in the non-trading book;

104.4. assessment and supervision of the impact of changes in the fair value of instruments caused by changes in credit spreads;

104.5. maintenance of information systems and accuracy and timeliness of information provided in information systems (including the management information system);

104.6. compliance with the principle of division of duties;

104.7. compliance with the requirements of laws and regulations and also of the approved internal normative documents of the institution;

104.8. transparency of decision-taking, allowing to identify deviations from the credit spread risk policy and procedures, and decisions that have been handed over to decision-taking at a higher level.

105. The institution shall ensure separate assessment of credit spread risk and other risks, including interest rate risk.

106. The institution shall ensure that any assumptions about diversification between credit spread risk and interest rate risk or other risks are documented and approved, credibility and stability thereof are tested using historical data that are suitable to the respective institution and markets in which it operates, and also the impact of diversification is stable in economic downturn and under market conditions that are unfavourable to the operations and risk profile of the institution.

**9. Determination of the Amount of Capital Necessary to Cover Interest Rate Risk and Credit Spread Risk**

107. The institution shall establish a justified, efficient, and comprehensive process to continuously assess and ensure the capital necessary to cover inherent and potential interest rate risk and credit spread risk of the current and planned operations of the institution and also determine the elements and structure of such capital.

108. The process carried out by the institution to assess the amount of capital necessary to cover interest rate risk shall include both the quantitative assessment of capital adequacy and the qualitative aspects. The institution shall additionally analyse the need to allocate additional capital to cover the credit spread risk.

109. The institution shall ensure that the process and result of assessing the capital adequacy necessary to cover interest rate risk and credit spread risk are fully documented, reflected in its report on the process of assessing the capital adequacy, and used in capital assessments related to the relevant operational areas.

110. When determining the amount of capital necessary to cover interest rate risk, the institution shall comply with the requirements of regulatory provisions of Latvijas Banka for establishing the process of assessing capital adequacy.

**10. Closing Provisions**

111. The Financial and Capital Market Commission’s Regulation No. 190 of 20 October 2020, Regulations for the Management of Interest Rate Risk, Calculation of the Reduction in the Economic Value, and Preparation of the Report on the Term Structure of Interest Rate Risk (*Latvijas Vēstnesis*, 2020, No. 210), is repealed.

112. Sub-paragraphs 56.1 and 56.2, Paragraphs 58 and 63, and Sub-paragraph 71.2 of this Regulation shall be applicable from the day when the directly applicable legal acts of the European Union referred to therein come into force.

113. The Regulation shall come into force on 31 December 2023.

Governor of Latvijas Banka M. Kazāks