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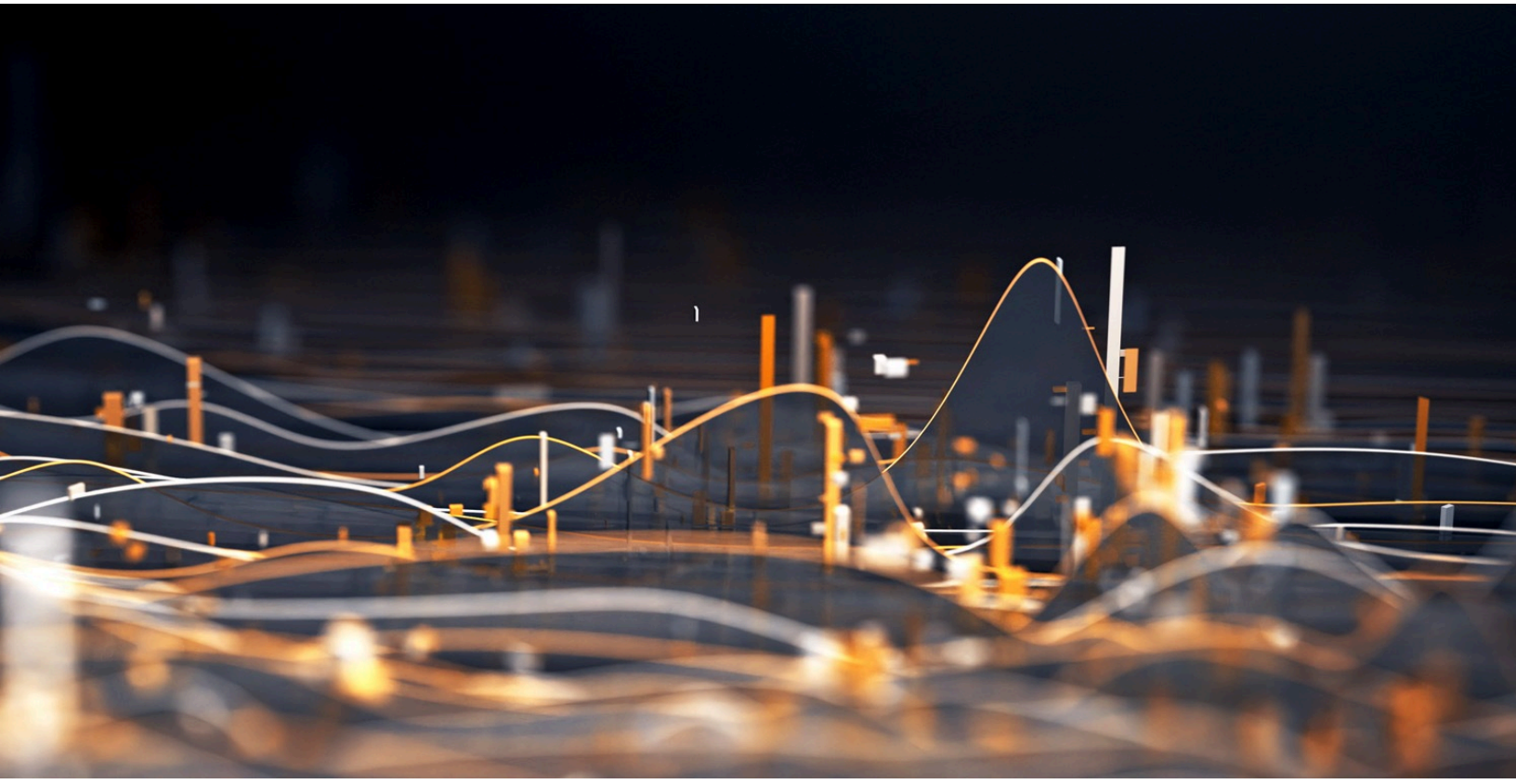
Risk & Resilience Practice

Confronting new risk management guidelines for credit spread risk in banking

In both the European Union and globally, the new supervisory expectations for credit spread risk in the banking book pose a clear challenge for bank treasury and risk functions.

This article is a collaborative effort by Andreas Bohn and Javier Martinez Arroyo, with Arash Dabiri, Enrique Briega, Marc Mitrovic, and Tomás Silveira, representing views from McKinsey's Risk & Resilience Practice.



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Banks in Europe and the United States are on a long-term bond binge, driven by factors such as regulatory requirements for liquidity reserves, higher yields, and reduced buying by central banks. Institutions on either side of the Atlantic collectively hold more than $6 trillion in sovereign and related securities alone, along with plenty more in lower-rated securities.[1] The vast volumes of these bonds that are not traded are under rising regulatory scrutiny, particularly in the European Union, where the European Banking Authority (EBA) has warned of potential material losses from credit spread risk in the banking book (CSRBB) and has published guidelines to support oversight.[2] In this context, the challenge for treasury teams is how best to interpret EBA guidance while ensuring they retain optimal levels of liquidity to meet their operational needs.

In Europe, banks are required under EBA guidelines published in 2023 to assess and monitor CSRBB in their risk management and capital assessment processes.[3] The biggest risks are presumed to be in widely held asset classes such as sovereign and financial institution debt, particularly in longer tenors. Although US banks are not directly bound by European regulation, the European Union's approach affects US banks operating in Europe and may more widely affect global Basel Committee standards. CSRBB risk may also factor into US regulatory scrutiny of liquidity and capital buffers.

According to an EBA quantitative impact study, more than 90 percent of European bank CSRBB exposure arises from liquidity reserves, with the asset composition of the liquidity buffer having a significant impact on capital requirements.[4] Under the Bank for International Settlements definition, securities that are eligible as high-quality liquid assets (HQLA) account for about 50 percent of European bank liquidity reserves on average, and a significant 10 percent of balance sheets, albeit with significant national variations, the EBA says.[5]

Following publication of the EBA guidance, European banks have started to allocate significant amounts of Pillar 2 capital to CSRBB. But approaches and allocations vary across the market, including how banks interpret the scope of included instruments and the definition of credit spreads. Many banks, meanwhile, have moved to impose concentration limits on their portfolios, which has a constraining impact on their capital allocations.

In this article, we discuss four aspects of the EBA's CSRBB guidelines that continue to provoke industry discussions. We highlight how some leading banks are tackling these dimensions within the ambit of their risk management frameworks and discuss a potential approach that could amount to a blueprint for CSRBB risk management throughout the economic cycle.

Interpreting the EBA's guidance

In its guidelines, the European Banking Authority encourages banks to measure the impact of changing credit spreads on both their economic value of equity (EVE) and their net interest

[1] Federal Reserve Bank of St. Louis data; "Europe's sovereign-bank nexus: Old habits, new risks," S&P Global, November 2023.
[2] "Are banks prepared for interest rate and credit spread shocks?," European Central Bank, August 17, 2022.
[3] *Final report on guidelines on the management of interest rate risk and credit spread risk arising from non-trading book activities*, European Banking Authority, October 20, 2022.
[4] *Final report on guidelines on the management of interest rate risk and credit spread risk*, October 2022; while the study is from 2022, we believe the observations remain broadly accurate.
[5] *Report on liquidity measures under article 509(1) of the CRR*, European Banking Authority, December 2024.

income (NII). This much is clear, but across the market, there is continuing uncertainty over four key guidance areas:

— *the CSRBB perimeter*, or the scope of assets and liabilities subject to CSRBB

— *the separation of spread elements*, including the market liquidity spread and the market credit spread elements arising from idiosyncratic credit spread movements (excluded from the framework)

— *the measurement approach*, particularly whether CSRBB is calculated using predefined shocks or a chosen distribution, as well as the approach to integrating into the overall economic capital calculation

— *allocation of resources and limit setting*, and orientation in the overall internal capital adequacy assessment process (ICAAP) framework

Each of these elements can affect how banks manage liquidity reserves, and thus requires careful evaluation based on an understanding of the full costs and benefits of different options. Here, we show how some banks are addressing the challenge.

Gauging the perimeter

Where should banks draw the line on what falls within the scope of CSRBB and what does not? The EBA says that banks are free to decide but must justify items not included and should not preemptively exclude any instrument in the banking book, regardless of its accounting treatment. Indeed, banks should consider assets, liabilities, derivatives, and other off-balance-sheet items such as loans.[6] Where banks do exclude items, they must be able to show the absence of sensitivity to credit spread risk. Broadly speaking, we see seven main categories of balance sheet items that should be considered for inclusion (Exhibit 1).

In our contacts with banking leaders, the majority approach has been to include all securities definitively in the banking book and then consider whether any other securities may also qualify. To aid in decision-making, the European Banking Federation has published a useful decision tree, reflecting the criterion laid out in the guidelines based on whether there are reliable and observable market prices for any particular security.

One area where there is considerable uncertainty is liabilities, particularly fixed-income securities. Although there is little argument that banks' own bonds are affected by changes in market credit spreads, some banks, and also maybe regulators, are not comfortable with the implications—specifically, that they could see a rise in their economic value of equity (an offsetting factor in liquidity reserve terms) from a deterioration in peer credit spreads. One idea to address this challenge would be to consider different approaches for calculating EVE and NII sensitivity measurements and risk appetites.

[6] *Final report on guidelines on the management of interest rate risk and credit spread risk*, October 2022.

Exhibit 1

Seven broad asset classes may contribute to credit spread risk in the banking book.

Level of relevance for credit spread risk in the banking book (CSRBB), by instrument

Relevance: High Medium Low

Bonds	Seen as key sources of CSRBB by most banks. Almost all banks include FVPL[1] and FVOCI[2] bonds. Bonds held at cost are usually included as well.
Performing loans	FVOCI and FVPL loans are often seen as secondary source of CSRBB. Price changes are less easy to observe in the market.
Nonperforming loans	Explicitly excluded from the perimeter of CSRBB.
Own issuances	Prices and yields can be directly derived from the market. Deterioration of an institution's credit quality should not have any positive impact on the risk measure.
Derivatives	Instruments to be covered by another framework, eg, credit value adjustment (CVA).
Repos and reverse repos[3]	Instruments to be covered by another framework, eg, CVA.
Pensions	Instruments to be covered by dedicated framework for pension risks.

[1]Fair value through profit or loss.
[2]Fair value through other comprehensive income.
[3]Repurchase agreements and reverse repurchase agreements.
Source: EBA/GL/2022/14, 20 Oct 2022

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Taking in the separation of spread elements

Recognizing that the economic and geopolitical landscape is inherently, and increasingly, uncertain and prone to bouts of volatility, regulatory guidance on CSRBB risk management aims to capture two key ways in which CSRBB can manifest[7]:

1. Changes in the "market credit spread" or the "market price of credit risk" (distinct from the idiosyncratic credit spread) represent the credit risk premium against the risk-free rate required by market participants for a given credit quality.

2. Changes in "market liquidity spread" represent the liquidity premium that sparks appetite for investments and fosters the presence of willing buyers and sellers. This may be seen as the spread between market term rates and overnight index swap rates (for example, the interbank offered rate [EURIBOR] versus the euro short-term rate [ESTR]) or the funding costs of haircuts on sovereign debt.

[7] *Final report on guidelines on the management of interest rate risk and credit spread risk*, October 2022.

The combination of market spread and liquidity spread amounts to a distinct new lens on risk that notably does not consider credit ratings or creditworthiness, does not overlap with credit valuation adjustment, but does encompass currency dimensions.

Given these specifications, the EBA is clear that CSRBB would be best managed under a dedicated framework defined by robust risk policies and processes, for example in relation to measurement, model assumptions, and lines of responsibility. In addition, the framework should incorporate systems and standards for monitoring, valuing, and assessing exposures, as well as a comprehensive reporting and review process, effective internal controls and management information systems, and finally a defined risk appetite to aid decision-making.

Measurement approach

Banks can take one of several different approaches to CSRBB calculation, including stress testing (for example, increase to a certain percentile of observed spreads), standardized shocks (for example, +/–100 basis points, in the spirit of interest rate risk in the banking book [IRRBB]), or measures of sensitivity (CS01), value at risk, or expected shortfall. Overall, we see four approaches that are attracting interest:

— CS01 measures the change in asset value per one basis point change in spread. It is typically measured by empirical correlations of spreads between asset classes.

— Standard shocks are measured according to regulatory expectations or historical volatility and can be based on assumptions indexed to historical correlations.

— Stress tests measure the impact of extreme but plausible market conditions on overall asset composition. They are often based on assumptions or use historical worst-case correlations.

— Credit spread value at risk, or CSVaR, is a distribution-based estimate of loss over a defined period for a given confidence level due to changes in credit spreads. Historical spreads are used as inputs.

While many banks are considering multiple options, we see most going in one of two directions:

1. *Basic approaches (options one and two above).* Banks for which CSRBB is less material are typically focused on the vulnerability of credit spreads to +/–100 basis point movements in EVE and NII. The logic is to minimize complexity and operational investment until further guidance is provided by the supervisor.

2. *The most economically coherent approach (option four above).* Some banks feel that the most productive and economically sensible approach is based on value at risk or expected shortfall. This option considers the correlation matrix of credit spreads and hence diversification effects. It is also practical in terms of available tools and makes the most meaningful contribution to economic capital calculations.

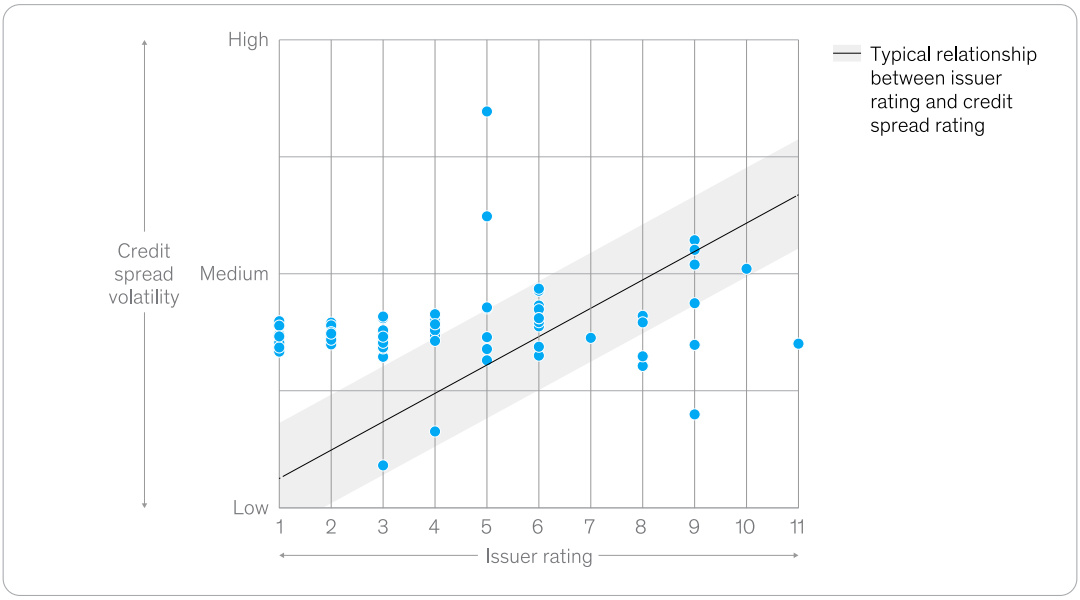
Allocation of resources and limit setting

When it comes to resource allocation and limit setting, institutions currently adopt a variety of approaches, with, for example, some banks choosing to set limits by issuer and others focusing on spread class or credit rating. Our analysis shows that issuer rating and historical credit spread volatility are not necessarily strongly correlated (Exhibit 2). However, factors such as maturity and liquidity are relevant to decision-making.

Exhibit 2

Credit spread risk does not necessarily correspond to credit rating.

Credit spread volatility vs issuer rating for European Central Bank–eligible bonds, 5-year maturity



Source: Bloomberg; McKinsey analysis

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A key question for banks is how much Pillar 2 capital they should hold against the risk. Here, a pertinent question will be how to calculate capital in the context of risks such as credit valuation adjustment (CVA), IRRBB, jump-to-default risk, and market risk. Certainly, initial calibration of CSRBB economic capital presents banks with a unique opportunity to align with supervisors on an approach that avoids excessive risks.

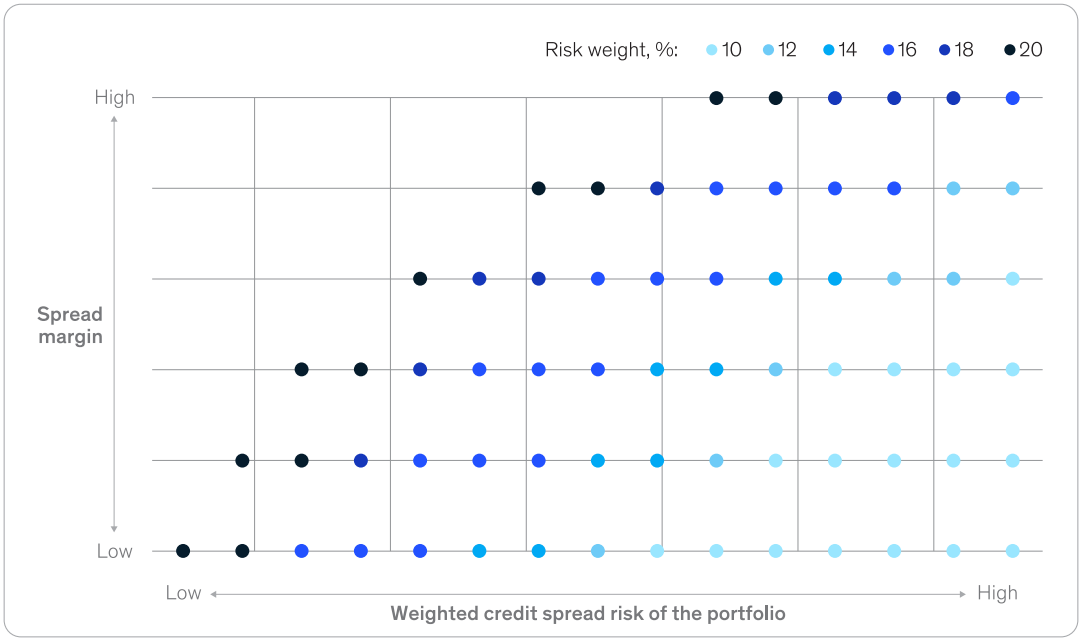
Making the most of the liquidity reserve

Following the definition of the most important elements of a CSRBB risk appetite framework, the task will fall to the treasury team to find an optimal allocation for the liquidity reserve, bearing in mind the efficient frontier based on asset volatility (Exhibit 3).

Exhibit 3

Treasury teams will gauge liquidity reserve allocations based on efficient frontier calculations.

Spread margin and correlation weighted CS01,[1] low to high (illustrative)



[1]Measures of sensitivity to credit risk spread.

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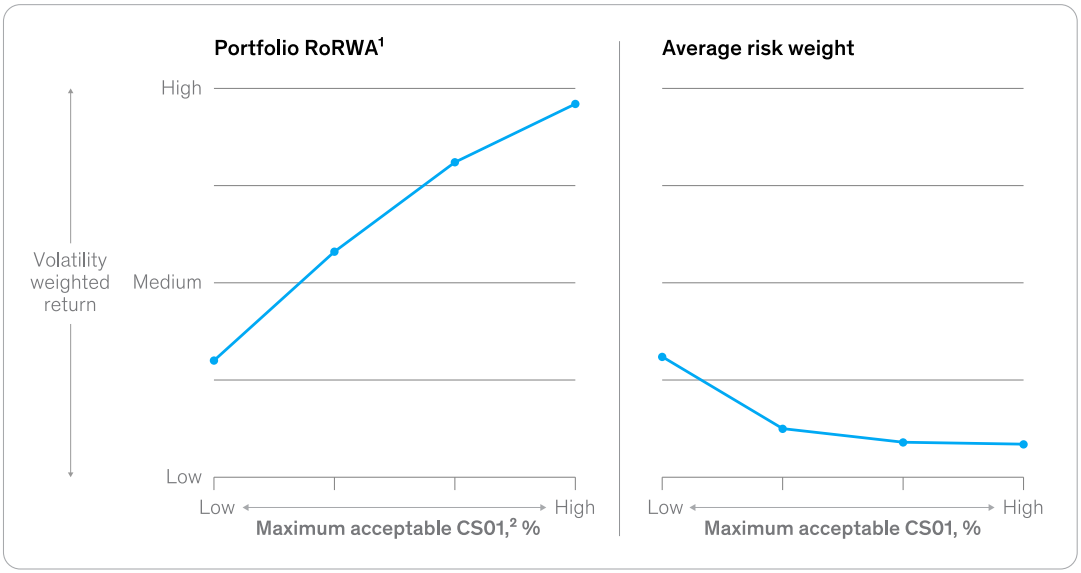
In making liquidity reserve decisions, there will be an inevitable trade-off between risk and return, but also, and less intuitively, between different types of risk (Exhibit 4). For example, credit spread risk (measured by CS01) and credit default risk (as represented by risk weights in the standardized approach for calculation of prudential capital according to Basel III rules) can be balanced to achieve a specific yield.

This trade-off is also visible with reference to the efficient frontier in classic portfolio theory, represented by the portfolio with the lowest CS01 for a given spread level.

Exhibit 4

Trade-off between higher CS01 measures of sensitivity and higher risk weight requires diligent management.

Comparison of risk-weighted assets objective function, illustrative



[1]Return on risk-weighted assets.
[2]Measures of sensitivity to credit risk spread.

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In both the European Union and globally, the new CSRBB supervisory expectations are a clear challenge for bank treasury and risk functions, at a time when teams are already faced with wider credit spreads and stronger differentiation among borrowers. Despite these parallel and often significant challenges—indeed, because of them—banks should see the benefits and opportunities in proactively getting a grip on the EBA guidelines and the decisions that will shape oversight in the future. The good news is that effective management of the liquidity buffer is a route to multiple CSRBB benefits, including safer operations and preparedness for shifts in both market and regulatory landscapes.

Andreas Bohn is a partner in McKinsey's Frankfurt office, where **Marc Mitrovic** is an expert; **Javier Martinez Arroyo** is a partner in the Paris office, where **Tomás Silveira** is an associate partner; **Arash Dabiri** is a senior fellow in the Stockholm office; and **Enrique Briega** is a knowledge expert in the Madrid office.