

Regulatory Update

How will the Basel Committee's SA-CCR regulation affect Misys customers?

The new regulation around counterparty credit risk exposures will have an impact on Misys customers. Richard Platt, Product Manager for FusionRisk at Misys explains how customers can prepare.



Richard Platt

Senior Product Manager,
FusionRisk, Misys

The Basel Committee's main objectives of introducing the "Standard Approach for Counterparty Credit Risk" (SA-CCR) were "to devise an approach that is suitable to be applied to a wide variety of derivatives transactions (margined and unmargined, as well as bilateral and cleared); is capable of being implemented simply and easily; addresses known deficiencies of the CEM and the SM; draws on prudential approaches already available in the Basel framework; minimises discretion used by national authorities and banks; and improves the risk sensitivity of the capital framework without creating undue complexity".*

The Basel Committee is replacing the formulation for the measuring of Exposure At Default (EAD) for Counterparty Credit Risk (CCR).

This method is referred to as the new Standard Approach for Counterparty Credit Risk (SA-CCR). The method will replace the Current Exposure Method (CEM) and the Standard Method (SM). The method was finalised in the document.

“Early compliance with SA-CCR can bring capital efficiency as well as competitive advantage.”

* <http://www.bis.org/publ/bcbs279.htm>

The Basel Committee aims to target important criticisms of the existing methods:

- The CEM does not differentiate margined/un-margined transactions.
- The CEM did not adequately model recent volatility observed in recent period of stress
- The SM “hedging set” approach led to operational complexity or inability to implement
- The SM was not a true non-internal model alternative as the Standard Method still relied on internal methods for delta equivalent calculations.
- Furthermore the existing framework was insufficiently risk sensitive, not aligned with other prudential approaches and did not incentivise central clearing of derivative transactions.

The SA-CCR method is scheduled to come into effect on **1 January 2017**, at this same time the IMM shortcut method will be removed from the capital adequacy framework.

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What is the approach?

The exposures under the SA-CCR consist of two components: replacement cost (RC) and potential future exposure (PFE). Mathematically:

Exposure at default under SA = EAD = alpha * (RC + PFE)

where alpha equals 1.4, which is carried over from the alpha value set by the Basel Committee for the Internal Model Method (IMM). The PFE portion consists of a multiplier that allows for the partial recognition of excess collateral and an aggregate add-on, which is derived from add-ons developed for each asset class (similar to the five asset classes used for the CEM, i.e. interest rate, foreign exchange, credit, equity and commodity).

The methodology for calculating the add-ons for each asset class hinges on the key concept of a “hedging set”.

A “hedging set” under the SA-CCR is a set of transactions within a single netting set within which partial or full offsetting is recognised for the purpose of calculating the PFE add-on. The add-on will vary based on the number of hedging sets that are available within an asset class. These variations are necessary to account for basis risk and differences in correlations within asset classes.

What are the methodologies for calculating the add-ons?

- Interest rate derivatives: Hedging sets are constructed for those trades that are sensitive to the rates in the same currency and then further divided into maturity bands. Long and short positions in the same hedging set are permitted to fully offset each other within maturity categories; across maturity categories, partial offset is recognised.
- Foreign exchange derivatives: A hedging set consists of derivatives that reference the same foreign exchange currency pair. Long and short positions in the same currency pair are permitted to perfectly offset, but no offset may be recognised across currency pairs.
- Credit derivatives and equity derivatives: A single hedging set is employed for each asset class. Full offset is recognised for derivatives referencing the same entity (name or index), while partial offset is recognised between derivatives referencing different entities.

- Commodity derivatives: Four hedging sets are employed for different classes of commodities (one for each of energy, metals, agricultural, and other commodities). Within the same hedging set, full offset is recognised between derivatives referencing the same commodity and partial offset is recognised between derivatives referencing different commodities. No offset is recognised between different hedging sets.

What will be the likely impact on the banks business?

Dependent on whether an internal model or standard approach will be chosen by the bank and which model was used to date, the impact on running parallel models and the associated data requirements are likely to be significant.

In some cases, as the result of the credit risk exposures contributes directly to the Basel III capital requirements, drastic increases or decreases of capital charges can be expected in some cases. Banks are therefore advised to start early with assessing and planning their path to compliance and to select the most appropriate model for their portfolio.

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How can Misys help?

Misys is continuing to make significant investments in its solutions to help customers find their path to compliance with major regulatory requirements. SA-CCR is only one of many other examples where Misys responds to the regulatory pressures with a packaged SA-CCR solution as part of the FusionRisk product line. The SA-CCR solution allows banks to run different approaches in parallel and leverages FusionRisk's Limits processing platform.

“FusionRisk's compliance with SA-CCR allows banks to be fully SA-CCR compliant where they can run different approaches in parallel.”

Can Misys offer full SA-CCR instrument coverage?

Yes. FusionRisk offers the ability to accommodate foreign exchange, credit, commodity, equity, interest rate derivatives and their associated spot/forward hedges as per the Basel regulatory formulation. Existing customers will simply need to categorise their existing instrument definitions into the regulatory categories.

Regulatory coefficients for each instrument or aggregation are parameterised in the system, as is the computation itself. This protects Misys clients from future changes to the regulation that could result in computational adjustments. The computational configuration is open for Misys customers so that validation and audit procedures can be quickly implemented. Misys customers can modify and/or extend the computation if required.

Trading exposures can be incorporated in batch or real-time as trades are executed. SA-CCR exposures are updated in real-time using a fast event driven computation engine.

Can Misys FusionRisk handle SA-CCR collateral computations?

Yes. SA-CCR includes a regulatory treatment of collateral and margin period of risk adjusted exposures. FusionRisk models the appropriate collateral and collateral agreement terms. External collateral management systems can be integrated to compute the SA-CCR margin adjusted exposures. Collateral can be posted either in batch or real-time.

How will you be able to follow and analyse computed exposures?

FusionRisk offers analytical visualisation as part of the SA-CCR package. SA-CCR introduces hedging sets and complex aggregation which complicates analysis and attribution of the resulting exposures. A dedicated dashboard that shows the breakdown of the aggregation to the class/sub-class level with trade level contributions is critical in maintaining and understanding SA-CCR computed exposures.

Does FusionRisk offer full limit integration?

Yes. The standard functionality such as pre-deal check analysis, excess approval and limit reporting all are applicable with the SA-CCR based exposures.

In addition, post and pre-deal checks are computed in real-time thanks to new events-driven technology. Misys has invested in a new limit and exposure aggregation technology platform that can accommodate the technical challenges implied by the new methodology. An event driven engine computes exposure aggregation and limit dependencies in real-time allowing users to see exposure updates as they occur.

What can FusionRisk offer for those computations that require qualitative interpretation?

FusionRisk can offer flexible mapping for those SA-CCR computations that require qualitative interpretation. For exotic trades users can customise the trade mappings and computational approach to fully conform to the regulatory approach.

Can Misys FusionRisk incorporate SA-CCR computation for regulatory reporting?

Yes. SA-CCR determines the Exposure at Default (EAD) that is necessary to then compute the RWA, the regulatory capital and the regulatory reports. Once the SA-CCR contribution is done at the deal level, this contribution can be sent to FusionRisk Regulation to compute the RWA and produce the regulatory reports.

What do I need to get this implemented?

The Misys SA-CCR solution is an upgrade for existing FusionRisk clients. Most clients with existing FusionCapital installations need only install or upgrade their FusionRisk solution to incorporate SA-CCR compliant limit monitoring and controls. Some customization or upgrade of existing FusionCapital installations may be required depending on client versions.

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About Misys

Misys is at the forefront of the financial software industry, providing the broadest portfolio of banking, capital markets, investment management and risk solutions available on the market. With more than 2,000 customers in 130 countries our team of domain experts, combined with our partner eco-system, have an unparalleled ability to address industry requirements at both a global and local level. We connect systems, collect data and create intelligent information to drive smarter business decisions. To learn more about how our Fusion software portfolio can deliver a holistic view of your operations, and help you to solve your most complex challenges, please visit misys.com and follow us @MisysFS on Twitter.

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About FusionRisk

Misys FusionRisk addresses the strategic regulatory and risk management requirements of a bank across the trading, lending and banking books.

The solution is helping risk managers to see risk, by bringing up-to-date risk figures, analysis and optimisation tools to key decision makers. Credit, market and liquidity risk can be analysed from one place, and regulatory capital, liquidity coverage ratios and stress tests can be managed to alleviate regulatory pressures.

With Misys FusionRisk, banks can build their risk intelligence incrementally, using component-based tools that augment existing systems with regulatory compliance and innovative technology.

FusionRisk - if you can't see risk you can't manage it.

misys.com/FusionRisk



For more information visit
misys.com/FusionRisk



Contact us at
FusionRisk@misys.com



Telephone
+44 203 320 5000

Corporate headquarters

One Kingdom Street
Paddington
London W2 6B
United Kingdom

T +44 20 3320 5000

