Misys FINANCIAL SOFTWARE

Misys **Fusion**Risk

Regulatory Update

How will the Interest Rate Risk in the Banking Book (IRRBB) affect financial institutions?

The finalised regulation of the Interest Rate Risk in the Banking Book (IRRBB) will have an impact on Misys customers. Michel Dorval, Regulatory Architect at Misys, summarises the main implications of this framework, the overlaps with other regulations and the main areas it will affect.

Michel Dorval
Regulatory Architect,
Misys

What is IRRBB and where are we today?

Interest Rate Risk in the Banking Book (IRRBB) is the risk to earnings or capital arising from movement of interest rates, which has always been subject to a Pillar 2 approach under the Basel framework. The Basel Committee tried to apply a Pillar 1 treatment but it failed due to strong resistance from the industry. The final guidelines of April 2016 created a stronger Pillar 2 component that takes into account latest industry trends and sets out supervisory expectations for banks' identification, measurement, monitoring and control of IRRBB, as well as its supervision.

IRRBB covers broadly three types of risk:

1. Gap risk – the risk arising from the timing of rate changes in the term structure of banking book instruments.
2. Basis risk – the risk of relative changes in interest rates caused by financial instruments that have a similar tenor but are priced with different interest rate indices.
3. Option risk – the risk arising from option derivative positions or optionalities in banks' assets, liabilities and/or off-balance sheet items, where the level and timing of the cash flows can be altered.

All three risk types covered by IRRBB can potentially adversely affect a bank's financial position by changes in the price/value or earnings/costs of interest rate-sensitive assets, liabilities and/or off-balance sheet items.

The revised standards are due to be implemented by 2018. The deadline for compliance with the revised IRRBB framework and dataset is 31 December, 2017. Therefore, action has to be taken now by national or supranational supervisors such as the European regulatory authorities to incorporate it into their regulatory framework.

What are the key changes that are introduced with the IRRBB regulation?

More detailed guidance
More direction has been given to key behaviour and modelling assumptions, application of stricter rules in shock and stress scenarios, and the importance of properly monitoring and assessing the credit spread risk in the banking book. Additionally, the threshold of the identification of an 'outlier bank' has been tightened (15% of a bank's tier 1 capital).

Enforce greater standardisation
The local regulator has the right to mandate banks to use a revised standardised approach. The approach is based on an Economic Value of Equity (EVE), together with a set of prescriptive rules for instruments along different classifications and a predefined set of interest rate shock scenarios.

Tightening in on governance: Governance processes should be well embedded in model risk management. The validation function should be independent of the development process. Measurement outcomes of IRRBB and hedging strategies should be reported to the governing body. In addition, banks must implement policy limits that keep IRRBB exposures consistent with their risk appetite.

More consistent disclosures: The disclosure requirements have been standardised and enhanced to promote greater consistency, transparency and comparability in the measurement and management of IRRBB. Banks must compute and disclose, among other requirements, the impact of interest rate shocks on changes in economic value of equity and changes in net interest income, based on a set of prescribed interest rate shock scenarios.

Which other regulations or risks will need to be considered in parallel?

The Credit Spread Risk in the Banking Book (CSRBB) will need to be monitored and assessed as part of the interest rate risk management framework. CSRBB refers to any kind of asset/liability spread risk of credit-risky instruments that is not covered by IRRBB and by the expected credit/jump to default risk.

In addition, IRRBB will need to be incorporated in the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), as well as specific regulations such as the Comprehensive Capital Analysis and Review (CCAR) in the US. LCR's assumptions around stressed outflows are a good example of where IRRBB will need to be additionally considered for any overlaps in data analytics, processes and systems.

In order to become compliant with IRRBB requirements, banks aiming to achieve best practice should now consider integrating their IRRBB analytics across all asset liability management processes and treasury systems to ensure conceptual consistency. This will help achieve more efficiencies and ultimately more accurate information across the banking book, which will allow banks to be able to respond more quickly to changing market conditions.

What will be the implication be on banks' business and infrastructure?

Banks need to take into account the commonalities with other key balance sheet frameworks such as liquidity risk, fund transfer pricing (FTP) and balance sheet optimisation when analysing behavior and modelling assumptions in more detail.

The focus on governance means that the current risk management framework needs to include all IRRBB models and assumptions. In addition, the limits used to manage IRRBB will also need to be extended so that risk managers can regularly review and calibrate interest rate risk limits and inform senior management about any threshold breaches. As a result, the new IRRBB requirements will force greater collaboration and closer alignment between treasury and risk management functions.

From an infrastructure point of view, banks will have to integrate advanced and flexible IRRBB engines that are capable of running multiple scenarios with different analyses and projections that can report the necessary disclosure requirements with the right level of detail.

How can Misys help financial institutions achieve IRRBB compliance?

Regulators are increasingly enforcing the concept of standardisation for IRRBB relating to modelling assumptions, specific disclosures, predefined scenarios and/or alternative standardised approaches. FusionRisk Balance Sheet Management helps banks to drive risk, capital and liquidity from one central place in their strategic planning cycle and link this to the day-to day decisions that need to be taken by senior decision makers. The solution allows banks to integrate risk and capital as part of a joined up cross-functional business strategy, where they can manage interest rate risk and gaps, foreign exchange and liquidity risks within an agreed risk return target. The solution supports and encourages sound risk management by delivering auditable processes around risk simulation, analysis, decision making and reporting.

Last Updated: August 2016

About Misys FusionRisk

Misys 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

About Misys

Misys is at the forefront of the financial software industry, providing the broadest portfolio of banking, capital markets, investment management and risk management 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 **www.misys.com** and follow **@MisysFS** on Twitter. For the latest news, interviews, videos and features from the financial technology industry visit **www.fusionwire.net**.

Corporate headquarters
One Kingdom Street
Paddington
London W2 6B
United Kingdom

T +44 20 3320 5000

MISYS FINANCIAL SOFTWARE

540 / 0816