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Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.

Global Risk Watch Newsletter

The background of a possible concerted policy shift by leading central banks, etc.

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2. Overview of Development in Financial Regulations (Trends & Topics)

 # Japanese banks need to step up for IRRBB implementation (Shiro Katsufuji, Director, Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

Implementation date is approaching for interest rate risk in the banking book (IRRBB) regulation, one of the Basel III reforms. In June, Financial Services Agency of the Japanese government (JFSA) published the draft amendments to the Supervisory Guidelines regarding the monitoring of interest rate risks, which will become effective in March 2018 for internationally active banks in Japan. The Basel Committee on Banking Supervision has concluded in 2016 to place IRRBB under Pillar 2 based on banks' internal control, and JFSA's draft is well in accordance with this decision.

For the following reasons, supervision based on banks' internal control are more suitable for IRRBB, rather than the Pillar 1 approach of standardized capital requirements. First, banking asset and liability structure and risk profile vary for each individual bank. Retention periods of non-maturity deposits (so-called "core deposits"), or prepayment rates of loans depend on various attributes of each bank's customer behavior. Even if figures on balance sheets appear identical, optimal modelling parameters and risks to be recognized differ depending on customers' behavioral traits. Second, banking book serves a crucial mission as financial intermediary, to provide funds to economy via loans and other means, and encourage growth of economy and enterprises. Imposition of uniform regulation could excessively constrain this intermediary function.

Simultaneously, to respect banks' internal control denotes that banks are accountable for their own risk management. IRRBB regulation requires internationally active banks to disclose information on their internal risk management policies, measurement techniques for interest rate risk, and core deposit models. Banks have to be prepared to provide sufficient explanation for stakeholders such as investors, customers, and regulatory authorities, on management of inherent interest rate risk of their large balance sheets. In order to set proper limits and utilize relevant measures, such as economic value of equity (EVE), net interest income (NII), and value at risk (VaR), it is vital to internally discuss and clarify fundamental policies for management of loans, deposits, and security holdings, based on assumptions on future interest rate volatility.

Risks of the banks' security holdings are a concern of various stakeholders. In the current financial markets, long-term interest rates are inclined to rise in anticipation for monetary policy normalization in the U.S. and Eurozone. Generally, lifting quantitative easing policies would increase banks' net interest income by steepened yield curves, while it would drive down economic value of their outstanding security holdings. In taking proper accountability for concerns from different perspectives, it is necessary for banks to review management of interest rate risk, models, and operational policies for asset liability management (ALM). Implementation of IRRBB regulation will serve as a vital opportunity for banks to reevaluate their risk management regimes, along with recent changes in market environment.