TRIM is an opportunity for banks

Banks heavily rely on internal models for their financial risk management. Roughly ten years ago, the Internal Ratings-Based (IRB) and Internal Model Approaches (IMA) were introduced under Basel II, allowing banks to estimate the parameters needed for the calculation of credit and market risk exposure and corresponding regulatory capital. IRB and IMA eligibility is dependent on banks' ability to prove to supervisors that they adhere to the minimum standards that are set under the Basel Accords. Adherence to these minimum requirements is meant to signal to both the supervisory authorities and financial market that a bank is capable to adequately determine the amount of required risk capital.

In recent years, however, internal risk models have come under pressure from public scrutiny. Financial markets and supervisors claim to have lost confidence that banks are fully equipped to adequately assess their risk exposure and the corresponding required capital. Several benchmark studies have exposed high variability in regulatory capital calculations that cannot be solely explained by differences in risk appetite or business models. Due to this unwarranted variability in Risk Weighted Assets (RWA), financial markets and supervisors find it difficult to compare banks to each other, resulting in a loss of confidence in regulatory capital ratios.

Drivers of RWA variability can be found in all stages of the modelling and reporting processes. Governance structures, including a lack of independency of (validation) functions, outdated and incomplete data and IT systems, variations and inconsistencies in key regulatory definitions and general methodological differences impact the outcomes of the internal models that estimate a bank's risk exposure.

Regaining public confidence in regulatory capital ratios is considered a top priority for the Basel Committee on Banking Supervision (BCBS), European Banking Authority (EBA) and supervisors such as the European Central Bank (ECB). With this goal in mind, the ECB recently embarked on the second phase of the targeted review of internal models (TRIM). The ECB will conduct comprehensive in-depth reviews of banks' internal models and model environments with the objective to reduce the unwarranted variability in risk model outcomes. The TRIM is one of the largest ECB supervisory operations to date and is intended to be finalised in 2019.

The on-site reviews that will be conducted at 68 selected banks will not only focus on modelling methodologies, but also on governance frameworks, model risk management, data and IT, and on proper documentation of all processes. The aim of these on-site inspections is to not only tests compliance with CRR and CRD regulations, but also to establish regulatory consistency and the creation of a level playing field by harmonising best practices. It is likely that experiences from TRIM will trigger new regulatory expectations for banks.

TRIM is an opportunity

A comprehensive assessment of banks' internal risk models will shed light on key challenges in Pillar I modelling areas[1]. The lessons learned will provide banks with valuable information. For this reason, banks should use the momentum that TRIM creates to take their risk model framework to the next level.

With the ECB on-site reviews covering all areas that are likely to impact model outputs, banks are faced with a unique opportunity to thoroughly assess the entire model landscape. A rationalised and simplified model landscape enables banks to adequately respond to future regulatory and business developments. High adaptability, through increased efficiency and reduced model development lead times, ultimately results in better risk estimates, reduced capital add-ons and reduced costs.

A key part of the TRIM is its focus on model risk management. The use of internal risk models within banks is often associated with an increase in intrinsic model risk. Banks are expected to identify, understand and manage this specific risk category. This creates an opportunity for banks to set up a simplified and transparent governance framework that thoroughly aligns all processes that deal with the model lifecycle.

Furthermore, with standardised models looming, the TRIM will impact regulators' and investors' stance on the reliability of internal risk models. The TRIM findings are likely to have considerable consequences for future regulatory developments. Restoring confidence in the accuracy of internal models is crucial for the future applicability of internal risk models. For this reason, the TRIM on-site reviews pose an opportunity for banks prove their models' worth and ensure their future use.

Lastly, internal risk models are increasingly used for purposes other than calculating capital ratios (e.g. the Use Test). The use of front-end risk model applications, such as instant credit scores, are viewed by banks as a key ingredient to remaining competitive in the current market climate. An adaptable model landscape makes it easier for banks to incorporate such market developments in their business strategy.

With all these regulatory developments it is easy to forget the long run strategic role internal models play for banks. The TRIM should not just be considered as a just hurdle to overcome, but as a stepping stone to elevate the model landscape to a comprehensive framework that is inherently designed to add value to the business, beyond compliance. Banks that use the momentum of the TRIM to strategically improve their model landscape will likely have a long-term competitive advantage.

[1] Credit, market and counterparty credit risk modelling.

Let's talk

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