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TRIM: making the most of a difficult task at a difficult time

In 2017 and 2018 the European Banking Authority (EBA) will devote significant resources to a formal and structured review of credit, credit counterparty and market risk models being used by banks that fall under the single supervisory mechanism. This exercise, known as TRIM (Technical Review of Internal Models), is intended to provide firm foundations for the ongoing use of internal models to set capital requirements for European banks. TRIM launched in 2015 and is scheduled for completion in 2019, with the majority of bank interactions taking place in the next 12 months.

TRIM is an ambitious and expansive programme. The reviews will be at least as onerous as those carried out for initial Basel II accreditation 10 years ago. While there is never a good time for such a review, the fact that TRIM is coinciding with the cut-over to IFRS 9 accounting standard for provisions, means that risk data and analytics teams within banks will come under considerable pressure – particularly for banks who are using Foundation IRB (Internal Ratings Based) approaches or who still have some high default portfolios on the standardised approach. Building the additional models for these portfolios required for IFRS 9 estimation will absorb resources that might otherwise have supported regulatory engagement.

Regulators are aware of the pressures and appear to have planned for banks making mistakes during the programme. Despite that accommodative stance, TRIM will inevitably require banks to update and amend their regulatory capital models. Some changes are already explicit. Banks which have not revised their risk models since their first Basel II accreditation will be asked to update their parameters to reflect their experience during the Global Financial Crisis. In particular, estimated future loss associated with any as-yet-unresolved defaults dating to the crisis will need to be data-driven, and performance during the crisis will need to be reflected in any estimation of the long-run probability of default.

Less overtly, TRIM's scope includes automated credit approval models, providing the EBA with an unparalleled opportunity to compare lending algorithms within the same jurisdiction. It is unclear whether, and how, this information will reach the public domain but banks should expect feedback on their credit scoring processes and stability of outcomes. Convergence in credit scoring, at least for retail banking, may emerge as a regulatory trend.

TRIM is not seeking to increase the level of capital required by the European banking system but a rebalancing between institutions and between portfolios within institutions is a likely outcome of the desire for standardised outcomes. Banks which position themselves early for this rebalancing, and which acknowledge the consequences of standardisation, will mitigate some of the programme's considerable costs. Some strategic topics for consideration are set out below:

1. Positioning for further convergence between risk data quality and financial assurance requirements
2. Regulatory control, Board accountability and model governance
3. The future of economic capital models
4. Planning for a homogenous outcome
5. Accelerating towards the future of retail credit risk management

Consideration 1: Regulatory requirements for risk data are converging with audit requirements.

One of the critical points of differentiation between risk data and financial data, even for the most advanced of internal ratings based banks, is that the data used to formulate credit estimates is not subject to positive assurance review. Ongoing problems with standardised risk disclosure are obliging regulators to expect greater and greater controls over risk data, as seen most clearly through the BCBS 239 initiative. TRIM extends BCBS 239 from regulatory outcomes to credit and market risk model inputs. This is one area where the coincident timing with IFRS 9 can benefit banks. Adding discipline to risk data sources so that provisioning models satisfy audit requirements will assist with TRIM findings.

There is no industry standard operating model for 2nd and 3rd line review of risk data. Organisations will need to decide where accountability for data quality lies. Sophisticated modelling teams can produce acceptable output from poor quality data but individual organisations' data quirks make standardisation more complicated, which in turn makes assurance difficult.

The increase in audit requirements for risk data marks the end of one regulatory experiment in risk quantification – that market discipline, via mandated disclosure in the form of pillar 3 reports, would bring about standardisation and control. The next two considerations likewise represent points of divergence from recent regulatory history.

Consideration 2: It's not the Board's problem anymore. Risk Analytics teams work for regulators now.

Accountability for risk model quality has not found a stable operating model since banks first started investing in them 25 years ago. Model ownership has variously belonged to first and second line teams. As models have become more important in the determination of regulatory capital and shareholder value, regulators have asked Boards to take more explicit accountability, mimicking their accountability for financial reporting but without the support from an equivalent assurance function. While derivative valuation models have been subject to audit, IFRS 9 marks the first time a bank has needed positive assurance over credit risk models.

In the years since Basel II, regulators have themselves become the primary arbiters of model quality. TRIM makes this structure explicit, simply as a result of scale. Every accredited model in every SSM (Single Supervisory Mechanism) bank in Europe is about to be re-assessed. In that environment, while Boards can oversee clear model development and validation process, they should recognise that it is the EBA who decide whether risk models are fit for use.

Recognising where accountability starts and stops for risk models changes a recent trend of asking bank Board directors to develop deep technical expertise. The risk of further increased regulatory influence over capital management arising from the EBA's control over model design and use is marginal in the face of existing regulatory authority over SREP (Supervisory Review and Evaluation Process) and stress testing outcomes.

Organisations may need to decide how the relationship between their analytics functions and the regulator should be managed, because it is becoming closer than the relationship between any other first or second line function. Boards should also consider where authority for proposing model changes is delegated.

Consideration 3: As differentiation in risk models is removed, has economic capital outlived its usefulness?

Before internal models could be used to set bank capital levels they were being used by some banks to assess the relative riskiness of different businesses and to provide guidance as to the actual level of capital required to support a bank's balance sheet. The case for economic capital models has been weakening for the last 10 years. Relative risk is measured almost as well by Advanced IRB regulatory models as it is by the usual economic capital model; controls over regulatory models are often higher; and capital levels are no longer set with reference to external debt ratings (as was the case in many economic capital frameworks) from a regulatory perspective referencing measurable and unmeasurable characteristics.

Proponents of economic capital will still claim that the models are necessary because they better reflect risk concentration. They will also argue that better models can create a competitive edge via RAROC (Risk Adjusted Return on Capital) pricing.

The first of these points will likely remain true after TRIM. Pillar 2 capital charges and credit concentration remain important concepts albeit less so for the majority of SSM banks with diversified balance sheets.

The second will be eroded by TRIM's expectation that banks operating in the same market should have similar risk profiles at portfolio level and consequently carry similar levels of capital. The myth of model-driven competitiveness is being challenged.

TRIM will also have the effect of increasing the cost of operating a regulatory capital framework, by increasing expectations over data and assurance, as mentioned above. This makes the cost-benefit trade-off between economic capital and regulatory capital a finer judgement than previously and banks will need to consider whether it remains appropriate to persist with an economic capital

framework, or whether to rely primarily on regulatory outcomes for their business decision-making.

Consideration 4: Planning for the impact of TRIM on capital management and customer pricing.

Reducing 'unwarranted variability when banks use internal models' is an explicit objective of the TRIM process. Regulators have several tools at their disposal to achieve that goal, with the two known approaches being to standardise application of the economic concepts 'through-the-cycle' and 'economic downturn' across different institutions operating in the same market. It is reasonable to conclude that the IRB risk-weights for equivalent portfolios will converge within jurisdictions, albeit wide variation across Europe may remain, given the different experiences of different economies during the Global Financial Crisis.

The prospect of greater convergence can be planned for. At the strategic level, local peer analysis will allow for the estimation of a current jurisdictional average risk-weights for each portfolio and applying averages, rather than institution-specific risk-weights, to a bank's balance sheet may yield insights for medium-term capital planning.

Banks using some form of RAROC-based pricing or portfolio valuation may also want to consider the signal derived from the application of jurisdiction average risk-weights rather than the IRB risk-weights or economic capital (see Consideration 3) currently being used.

Consideration 5: Accelerating the future of retail credit risk management.

Many organisations have a vision of retail credit risk management that is entirely automated. Loan approval and ongoing credit assessment is conducted by algorithm, and straight-through processing allows for seamless transmission of customer information to the bank and transmission of funds from bank to customer (and vice versa).

There are several reasons why the vision remains unachievable. TRIM addresses two of them by tackling data and modelling weaknesses and connecting the regulatory concerns. While the resources that would typically help banks achieve higher levels of automation are typically those who will be caught up in the TRIM exercise, having a model-driven strategy will place the effort required into context. Investment in credit process automation while the TRIM exercise is being undertaken may allow for a productivity dividend to offset some of the increased cost of model maintenance TRIM appears likely to require.

How can TORI help?

Banks can best position themselves for TRIM by preparing for the potential outcomes in advance. Organisations will reach their own answers to the questions raised above. TORI has designed a dynamic process that responds to these answers and sets out clear steps to assist with making the most of the TRIM process. We can support a project from conception through to completion, assisting with IT, analytics and reporting solutions.

About TORI

It takes courage to embrace change and transform your business. We know. We've been there. That's why we set up TORI Global. To be a credible alternative to the 'big four' within Financial Services – by putting real industry experience at the heart of consultancy. So our clients get the best independent advice and specialist expertise for the success they deserve.

We are truly global. Headquartered in London, with offices in New York and Dubai and recent expansions into Bangalore and Singapore, there is a TORI network across the globe with aggressive growth plans.

At TORI Global we believe that delivering success for customers relies on successful partnerships, and that successful partnerships are founded on the values of Trust, Openness, Respect and Integrity.

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