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Glass Half Full: Basel IV Presents Opportunity for Constructive Change, COVID-19 the Impetus

The COVID-19 pandemic is an additional catalyst for financial institutions to generate fundamental structural change as they seek to implement Basel reforms

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Basel IV is not just the most recent set of Basel III requirements that will require careful implementation by financial institutions (FIs); it is much more.

These revisions to the original Basel III framework, collectively known as 'Basel IV', will change almost all approaches to calculating Risk Weighted Assets (RWAs), which dictate how much capital banks need to hold against credit risk, market risk and operational risk. By implication, this could have a far-reaching impact on the business and operating models of FIs, particularly in the age of COVID-19 and beyond. With the global economy inexorably heading towards a new normal, it is now more important than ever for FIs to better align their strategic plans with what the future might bring.

The Basel IV rules seek to narrow the gap in RWA outcomes between the internal ratings based (IRB) approach and the standardised approach (SA). Currently, for certain asset classes, the IRB risk weights are significantly lower than those calculated under the SA approach. This is because they are based on the idiosyncratic risk of IRB banks' actual customers as well as on the bank's own default history.

The SA approach, on the other hand, uses a standard one-size-fits-all approach to risk weights, which is not based on individual customer risk but rather its risk category. To address this, and in an effort to attain more risk sensitivity, the new standardised framework aims to increase the number of 'sizes'.

A strategic approach

In Asia, banking systems are generally divided into heavy and light adopters of the IRB approach – Singapore and Korea are dominated by IRB banks, while in Indonesia and India banks largely use the standardised approach. China and Japan are in the middle of the spectrum. Given this jurisdictional fragmentation, there will likely be significant variances in how banks in Asia Pacific will be affected by Basel IV.

One of the changes under the new framework is the Output Floor. This is set at 72.5% of standardised RWAs, which will limit the capital benefits to IRB banks in future.

Basel standards: Deadlines and progress by jurisdiction

Basel Standard	Deadline	Australia	China	Hong Kong	Indonesia	Japan	Singapore	Korea
Revised Standard Approach for Credit Risk	January 2023	Consultation	Draft	Draft	Draft	Draft	Draft	Consultation
Revised IRB Approach for Credit Risk	January 2023	Draft	Draft	Draft	Draft	Draft	Draft	Consultation
Revised CVA Framework	January 2023	Draft	Draft	Draft	Draft	Draft	Draft	Draft
Revised Minimum Requirements for Market Risk	January 2023	Draft	Draft	Draft	Draft	Draft	Draft	Draft
Revised Operational risk Framework	January 2023	Consultation	Draft	Draft	Draft	Draft	Draft	Consultation
Revised Leverage Ratio	January 2023	Consultation	Draft	Draft	Draft	Draft	Draft	Draft
Leverage Ratio Buffer	January 2023	N/A	Draft	Draft	N/A	Draft	N/A	N/A
Market Risk Disclosures	January 2023	Draft	Draft	Draft	Draft	Finalised	Draft	Draft

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- Mahim Mehra
Senior Risk Advisor
AxiomSL

"This will result in tighter risk calculations that could lower banks' capitalisation and force them to slow asset growth to meet capital targets," according to Mahim Mehra, Senior Risk Advisor at AxiomSL. "Alternatively, IRB banks could be forced to shed capital intensive business lines and streamline operating models."

"Meanwhile, SA banks – absent counteracting regulatory changes – could report relatively stable to lower RWAs, everything else being equal. This in turn could help accelerate asset growth and market share, and result in a more favourable risk capital - return profile for some. The landscape of 'winners' and 'losers' in the industry could consequently shift."

The coronavirus pandemic, which has tested anew the operational capacity for banks and supervisors, has an additional impact on institutions globally. The Basel Committee's oversight body, the Group of Central Bank Governors and Heads of Supervision (GHOS), has responded by deferring the implementation dates of the outstanding Basel standards by a year to 1 January 2023 to free up banks' abilities to respond to the impact of COVID-19.

This deferral acknowledges the severity of the crisis facing financial institutions globally, while also recognising the challenges of implementing Basel IV. On the flip side, it gives more time to banks to take a strategic rather than tactical approach. This applies as much to FIs that are well down the path of implementing Basel IV as it does to those that have only recently begun the journey.

Architecture as a foundation

While the actual implications of Basel IV will depend heavily on the portfolio structures and business models of individual banks, preparation for 2023 will now also require revised scenario planning to assess the full impact of COVID-19. This is for both IRB and SA banks alike. In addition, new data management and reporting processes will also be needed, making it is increasingly critical for banks to adopt a holistic approach to implementation.

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"To address these challenges and prepare for Basel IV, FIs need to optimise their resources, including adapting flexible data management, regulatory reporting, and audit processes," Mehra said. "This will help to generate an outcome where risk weighted calculations – and therefore risk capital – can be optimised. For maximum benefit, existing transformation plans should also be modified to incorporate the impact of COVID-19."

"FIs must have access to flexible data dictionary architectures that enable data to be properly classified for Basel compliance. These architectures should also be able to accommodate seamless change management and appropriately incorporate and execute risk models as regulatory calculations and reporting requirements evolve."

Mehra continued, "credit risk models form the foundation of risk origination, measurement and monitoring. When executing model calculations, most large FIs use an IRB approach in an effort to optimise capital".

"However, developing custom-built credit risk models is complex. Hence, many FIs have invested heavily in the services of third-party consultancy firms that essentially monopolise a niche – developing and maintaining relatively costly risk models written in closed-source proprietary languages," he added.

In order to have the ability to perform IRB calculations, optimisations, regulatory reporting, and to access calculation histories and granular results for analytics, FIs need powerful risk calculation architectures.

"By incorporating their various models into a single risk and regulatory ecosystem, and strategically converting models to an open-source language, FIs can save costs"

"A powerful architecture provides the foundation for a range of complex Basel-related capital and liquidity calculations," Mehra argued. "By incorporating their various models into a single risk and regulatory ecosystem, and strategically converting models to an open-source language, FIs can save costs. Equally importantly, they can also transparently access their model inputs and outputs and gain complete data lineage."

A unified data set

The initial and recurring investment costs of building custom credit risk models are high, Mehra acknowledged. But because the model execution process is effectively a black box, banks also suffer a negative impact on decision-making due to a lack of transparency, including an inability to drill down and obtain full data lineage.

The benefits of full data lineage are clear: it allows FIs to granularly assess and identify the impact of change, better understand business requirements, maximise the value of risk and regulatory data, and deliver better and more actionable business intelligence. In addition, full data lineage facilitates compliance with the Basel principles for effective risk data aggregation and risk reporting under BCBS 239, while also fortifying an FI's ability to defend its audits.

Under Basel IV, several calculation and reporting obligations will also become more complex, thus requiring access to more granular data. Compliance needs will mandate transparency across all processes in all jurisdictions in which the FI operates, from data sourcing, calculations, enrichment and aggregation, to pre-processing, validation, and reporting.

"A key component in developing this transparency is establishing the ability to connect data lineages across different enterprise systems," Mehra said, adding that this can also help to manage operational risk and the implementation of other regulatory-driven changes.

Full data transparency can be achieved with reporting systems that are functionally able to cope with changing requirements and those that integrate with both the finance and risk architectures of FIs. At the same time, it enables banks to better mine the data they have and need to deliver to regulators. Arguably, this can lead to an enhancement of their own analytical capabilities and an improvement of internal risk management and decision-making standards.

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"There are obvious implementation challenges given the structural nature of some of the Basel IV reforms, but one can look at this from a glass-half-empty or glass-half-full perspective," Mehra said. "There is an opportunity here to create an internal framework that leverages a single unified data set, as opposed to two, three or four disparate ones. Removing silos will not only provide efficiency gains; in combination with a critical examination of the business profile, it can also lead to a more sustainable operating model."

The ability to identify and deal with data overlaps, coupled with access to organisation-wide granular data, will ultimately inform better internal practices and generate fundamental, positive changes in business models. This should arguably lead to the creation of an enduring competitive advantage over time, just as the new normal sets in.

"Viewed through the right lens, a challenge can readily become an opportunity," Mehra concluded.

Mahim Mehra is an accomplished Credit Risk professional with 35 years of experience in the field of risk management. He is currently a Senior Risk Advisor to AxiomSL. Prior roles include Head of Contributor Relationships at Credit Benchmark, Morgan Stanley's Co–Head of Credit Risk for Europe Middle East and Africa, and several senior positions within Citibank Asia.

Mahim has also consulted on projects for the United Nations, International Atomic Energy Agency, Citibank and BCG in the fields of risk, regulations and project evaluation. He graduated from the London School of Economics with an MSc (Economics) degree, as an INLAKS scholar.

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The platform can be deployed on premise or on the cloud. Its client base spans regional and global financial institutions with more than $43 trillion in total assets and investment managers with more than $11 trillion in assets under management. Its coverage encompasses more than 110 regulators across 55 jurisdictions. AxiomSL is in the top 20 of the Chartis RiskTech100® 2020 ranking.

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