



Basel III and ORM

Summary

The Basel III set of rules re-define eligible capital and lists a range of risk measures to arrive at a more resilient banking sector. These risk measures naturally focus on the trading book and complex securitisation exposures since these were a major source of losses during the 2008-9 financial crisis. The ensuing recommendations concern model refinements and add on further measurements to better capture risk exposure. The recommendations also reveal insufficient senior management involvement, inadequate risk processes, misunderstood products and an overreliance on models. These underlying causes are within the domain of ORM. That is why a full implementation of Basel III requires a general strengthening of ORM.

Dear reader,

Superficial reading would suggest that Basel III¹ has neglected ORM. True, it is not treated explicitly. It is merely one of over 20 risk types² mentioned in the framework paper. Indirectly, however, there are ORM implications on nearly every page. The proper implementation of the recommendations requires not only more elaborate models, but also requires better governance and oversight and much improved risk management practices. Which is where ORM comes in. This newsletter highlights two areas where ORM plays a significant role: Governance and Model risk.

Governance

The complexity of modern banking has fragmented the risk management function and has made it the domain of specialists. Basel III stipulates, however, that the board of directors and senior management need to be actively involved throughout the risk control processes. To achieve that, they will need to become far more knowledgeable about all sorts of risk. In addition, and perhaps principally, they must be on top of the risk management process itself. How is it organised? How is it staffed? How are reporting lines set? How are limits put in place and monitored? How are models developed, tested, validated and used? What are fall back procedures? What are exceptions? How are conflicts of interest dealt with? Etc. etc. This is indeed the core banking process and as a core banking process, it falls within the domain of ORM.

This senior management's involvement includes taking a lead role in integrating risk management in the risk culture of the bank. Especially this aspect goes way beyond reading a report and relying on the business' good behaviour. It requires formal attestation of the degree to which the bank's people, processes and systems are properly geared to deal with the extant risk environment. Senior

¹Basel III is not a single document but rather a series of enhancements to Basel II. The best coverage is given by the following publications, both by the Basel Committee on Banking Supervision: in Dec 2010: *Basel III: International framework for liquidity risk measurement, standards and monitoring* and the main paper of June 2011, *Basel III: A global regulatory framework for more resilient banks and banking system*. You can find these papers at: <http://www.bis.org/publ/bcbs188.pdf> and <http://www.bis.org/publ/bcbs189.pdf>.

²In no particular order, the Basel III documents refer to: liquidity risk, model risk, systemic risk, market risk, on-balance sheet risk, off-balance sheet risk, credit risk, credit valuation adjustment risk, foreign exchange risk, sovereign risk, counterparty risk, concentration risk, wrong-way risk, interest rate risk, basis risk, system-wide risk, reputational risk, inflation risk, price risk, contagion risk, and, yes, operational risk



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management and the representatives for the board of directors can show their grasp of the risk culture by participating in regular risk reviews. Next to the specific risk reports (covering credit, market, liquidity etc.), a separate overall report must be discussed which covers the people, process and system aspects of the risk management framework itself. This part also falls under the responsibility of ORM.

Model risk

Basel III identifies the need to pay more attention to model risk and singles out the overall excessive build up of leverage and the mis-specification of α^3 during the credit crisis as consequences of such model risk. Model risk is indeed a major contributor to the recent (and current) banking problems.

Model risk comes in many guises: from incorrect specification and erroneous data to technical and implementation errors. Business Continuity Management ('BCM') techniques can be used to address some areas of model risk regarding assumptions, boundaries and applicability. BCM operates on the very assumption that parts of the bank or the environment are not working as they normally would. One of the standards of BCM is to maintain an inventory of fall back procedures and alternative working methods, both from a process and a data point of view.

BCM is not a trivial exercise as many have banks who have had to deal with natural disasters have experienced. Dealing with financial disasters, however, is even harder since all parameters can shift beyond recognition and therefore it requires an even deeper preparation in terms of BCM. Model malfunctions are a special kind of 'business disruption' in the sense that they do not require an external trigger. They are inherent in the way models are built, tested, used and validated. Thus, the principles of BCM can be applied to the various stages of model building, testing and validation. Since no model is valid under all circumstances, they can thus be said to be defective from the word go and therefore always require a continuity plan along the principles of BCM.

Conclusion

Basel III is quite technical but at the same time provides ample links to ORM. Two areas that stand out in this respect are model risk and the board / senior management's role. The common factor in these two areas is that they transgress individual risk types and are concerned with the overall risk management framework and the risk management process itself. This need for proper controls and procedures surrounding the operation of the bank's risk system is, however, neither simple nor a one-off exercise. It will require considerable efforts of the bank's control functions (including internal audit) to satisfy the Basel III requirements. Let it be a test of the maturity of ORM to see how it deals with that challenge.

³ Alpha here refers to credit risk as defined in Annex 4 (§ 34) of the Basel II text. There, α is defined as 'the ratio of economic capital from a full simulation of counterparty exposure across counterparties (numerator) and economic capital based on EPE (denominator), *assuming they meet certain operating requirements*' (our emphasis). The Basel III text notes that model risk (mis-specification in assessing the α nominator) aggravated the wrong-way risk (§ 114).