"Risk Data and Reporting": time to strip away the technicalities and conceptions, and reassess your Basel III implementation

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High up on the regulatory mountain, sits the Basel Committee on Banking Supervision (BCBS) and its global directive Basel III, which all firms are working to implement through to 2019. Now is a good time to revisit one of the Basel Committee's key fundamental papers *"Principles for effective risk data aggregation and risk reporting"* - January 2013[1]. The principles outlined in this paper are integral to effective implementation of Basel III and thus should be constantly at the forefront of our minds and actions. This article provides a refreshed look at these principles, beyond technicalities and assumed conceptions.

Ensuring the board and senior management receive the right risk information

Let us first have a look at the wording of the title: "Effective Risk Data *Aggregation*". Data aggregation is often perceived as putting data together and from a numerical perspective; performing summations or other averages. It is often considered as *basic*, at least conceptually, but this is a common misconception and must not be underestimated.

"To enhance risk management and decision-making processes at banks" is the general objective of these principles and the first detailed objective is to *"Enhance the infrastructure for reporting key information, particularly that used by the board and senior management to identify, monitor and manage risks"*.

The primary beneficiaries of these principles, but by no means the only, is the board and senior management, as they bear the ultimate responsibility of the bank and make the most important decisions. This immediately positions and states the importance of the principles that are detailed, and thus the attention that should be paid to them and to their implementation.

Granular risk data is spread throughout the organization: in different systems, in different legal entities, in different departments. The board and senior management need a global and consolidated view of the bank's risks. Therefore granular risk data should come from all over the organization to the board in an organized and controlled manner and not via emails with spread sheets attached. If this is the case, then firms are running the risks of missing, forgotten, or out of date data, failed macros, failed interfaces etc. The bigger the organization, the bigger is the risk that such events can happen. Knowing the impact that risk information may have in senior decisions, banks must make sure such information provided to senior management and the board is reliable. Whether an organization is using the most advanced models or the most basic approaches, it must make sure that senior management and the board get the right risk information. So these principles apply to any one involved in a risk management function.

Data architecture and IT infrastructure: Automation is key

Banks must have a data architecture and IT infrastructure that fully support risk data aggregation capabilities and risk reporting under normal and crisis times.

During times of crisis everything needs to happen very quickly as value created by years of labour can be destroyed in a few weeks, days, even minutes. It is at this time that board and senior management must be sure of the risk information they receive, more so than ever. Focussing on the specific risk that appears to be the issue is not enough: all risk data needs to be up-to-date. Worth noting that subprime crisis lead to banks failures on liquidity, not on credit risk, so it is essential to monitor all risks and not just the most obvious at the time.

To achieve the desired and required response time to a crisis situation, automation is key. Without this, stress can lead people to make many more errors than in normal circumstances and with nearly no time to control or contain. Automation ensures that the same processes as in normal conditions will work effectively. It is therefore that the Basel Committee Principle 3 says:

"A bank should be able to generate accurate and reliable risk data to meet normal and stress/crisis reporting accuracy requirements. Data should be aggregated on a largely automated basis so as to minimise the probability of errors."

[1] http://www.bis.org/publ/bcbs239.pdf

What's common about risk and finance data?

"Controls surrounding risk data should be as robust as those applicable to accounting data" and "Risk data should be reconciled with bank's sources, including accounting data where appropriate, to ensure that the risk data is accurate." (Principle 3)

This is a real mind-set change that needs to happen in organizations and probably more specifically within the environment of risk professionals who are used to working with different data sets for different scenarios. Risk departments need to integrate the best control and reconciliation practices of finance into their risk data and reporting practices.

Can you associate the principles and their implications as per the Basel Committee?

Most principles can be summarized with one word, such as "accuracy" or "timeliness" which everyone has a good idea about. But the idea one usually has prevents understanding of the real depth and breadth of the principle. It is a useful exercise to associate an abstract from the principles with a word which best summarizes what the associated principle is detailing, such as below:

"A bank's board and senior management should promote the identification, assessment and management of data quality risks as part of its overall risk management framework." **Principle 1: Governance.**

"A bank should strive towards a single authoritative source for risk data per each type of risk." **Principle 3: Accuracy and Integrity.**

"Data should be available by business line, legal entity, asset type, industry, region and other groupings, as relevant for the risk in question." **Principle 4: Completeness.**

"A bank should be able to generate aggregate and up-to-date risk data in a timely manner while also meeting the principles relating to accuracy and integrity, completeness and adaptability." **Principle 5: Timeliness.**

"A bank should be able to generate aggregate risk data to meet a broad range of on-demand, ad hoc risk management reporting requests, including requests during stress/crisis situations, requests due to changing internal needs and requests to meet supervisory queries." **Principle 6: Adaptability.**

"A bank should maintain, at a minimum, (…) automated and manual edit and reasonableness checks, including an inventory of the validation rules that are applied to quantitative information." **Principle 7: Accuracy.**

"For example, an aggregated risk report should include, but not be limited to, the following information: capital adequacy, regulatory capital, capital and liquidity ratio projections, credit risk, market risk, operational risk, liquidity risk, stress testing results, inter- and intra-risk concentrations, and funding positions and plans." **Principle 8: Comprehensiveness.**

"A bank should routinely test its ability to produce accurate reports within established timeframes, particularly in stress/crisis situations." **Principle 10: Frequency.**

If a firm has not accurately associated the relevant actions to the associated principles then it would be wise to perhaps reflect if they are addressing each section appropriately.

Conclusion

One might conclude with principle 12 *"Supervisors should periodically review and evaluate a bank's compliance with the principles"* (i.e. Review) is the most important action, but this is not the case. The principles which precede the 12th are equally, if not more important, because if they are addressed correctly, then Principle 12 should merely be a case of signing off compliance.

The Basel Committee gives this fundamental conclusion:

"Strong risk management capabilities are an integral part of the franchise value of a bank. Effective implementation of the Principles should increase the value of the bank. The Committee believes that the long-term benefits of improved risk data aggregation capabilities and risk reporting practices will outweigh the investment costs incurred by banks."

As mentioned earlier, it can be greatly beneficial to take a step back and look at a project from its most simplistic point, making sure that the principles are being addressed accurately and efficiently. But if they are not, then action must be taken. Through application of this approach to the Basel III directive, firms can gain a clear picture of what they are aiming to achieve and whether or not they are on the right lines, highlighting any adjustments which need to be made, rather than consistently tying themselves down in the granularity of the directive.

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When you have to be right