



BANKING STAKEHOLDER GROUP

CONSULTATION ON EBA/DP/2015/01 ON
THE FUTURE OF THE IRB APPROACH

General Comments and Replies to Questions

BY THE EBA BANKING STAKEHOLDER GROUP

London, May 5, 2015

Foreword

The EBA Banking Stakeholder Group (“BSG”) welcomes the opportunity to comment on the Consultation Paper EBA/DP/2015/01 on the Future of the IRB Approach.

This response has been prepared on the basis of comments circulated and shared among the BSG members.

This response outlines some general comments by the BSG, as well as our detailed answers to some questions indicated in the Discussion Paper.

General comments

We welcome the opportunity to comment on the EBA’s Discussion Paper on the future of the IRB approach. This memo contains our feedback on the specific questions stated in the discussion paper.

We acknowledge the necessity for further harmonisation of the IRB approach across institutions and wish to thank the EBA for their efforts in this direction. However, we would like to highlight the following key remarks:

- Specific attention should be paid to the interference with IFRS 9 and the work of the Basel Committee. We stress our strong preference for a minimisation of a divergence between the Basel framework and the implementation of the European implementation in the CRR and also the avoidance of multiple, related changes being required over a limited time frame. For more details, see the answers to questions Q2, Q3, Q16, Q18 and Q23. We are not advocating the convergence of prudential IRB parameters (PD follows a TTC approach) with those used in accounting credit provisioning models (PIT approach in IGRS 9). See answer to question 23.
- We agree with the proposed prioritisation of changes, but believe the proposed timeframe is unfeasible. Besides the simultaneous stress on resources by IFRS 9, the length and uncertainty of the prior regulatory approval process are major sources of concern. Moreover, the length of the implementation periods seems too short, given that it is very likely that most, if not all, of institutions’ rating systems will require a thorough redevelopment. For more details, see the answer to question Q3.
- We do not see the added value or rationale for certain specific proposals, such as number-weighted LGD/CCF and the requirement that the estimated PD should not be less conservative than the long-run average of

one-year default rates estimated from available data. For more details, see the answer to question Q8.

- We also doubt the need for publication of additional disclosures and believe that modifications to the reporting framework should strive for maximum harmonization. The main principle should be that each reporting item should be asked only once. For more details, see the answers to questions Q17-Q19.

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Response to specific EBA questions

Q1: The proposed prioritisation of regulatory products is based on the grouping of such elements that in the EBA's view can be implemented in a sequential manner. Do you agree with the proposed grouping? If not, what alternative grouping would you suggest?

We agree with the proposed grouping. It is indeed logical to start with the definition of default (as it is the central factor in the overall IRB process) and the more general topics, before moving to the modelling related topics and the credit risk mitigation framework. Guidance related to the definition of default will likely be considered among the BCBS policy measures on which consultation is expected by Mid-2015, as was announced in the BCBS's November report to G20, and consistency with global criteria should be pursued.

Q2: What would you consider the areas of priorities?

Apart from the proposed prioritisation, we would additionally focus on aspects related to the PD and LGD modelling and their possible interference with IFRS 9 requirements. This project has strong links with prudential requirements, and any change required in this respect is best known as early as possible.

Another major concern is the simultaneous work of the Basel Committee on this topic. We would like to stress our strong preference for an alignment with this work, not only from a content perspective, but also with respect to timing. In any case we would like to avoid making multiple, related adjustments over a limited time frame. If this would mean that the proposed planning should be adjusted, we think this will be justified and well worth doing.

Q3: Do you consider the proposed timeframe reasonable? In particular do you consider reasonable the proposed timeline for the implementation of the changes in the area of:

- a. definition of default;**
- b. LGD and conversion factor estimation;**
- c. PD estimation;**
- d. treatment of defaulted assets;**
- e. CRM?**

We strongly question the feasibility of the proposed timeframe for a number of reasons:

- Firstly, the overlap with the implementation period of IFRS 9: both the changes to the IRB approach and to IFRS 9 will draw heavily on modelling and validation resources. The proposed timeframe should take into account this simultaneous pressure on resource requirements.
- Secondly, the required prior approval by the competent authorities for material changes: this process is a major source of concern as it is out of our control. In our experience with the new regulation on materiality of changes, this process can take a very long time. The uncertainty about the time required for regulatory examination of these changes further complicates an already very difficult and extensive planning exercise. This issue is further aggravated by the accumulation of model changes submitted by different institutions in a short time period, and by the involvement of multiple competent authorities. Hence, we propose that the EBA works out, together with the competent authorities, a realistic and efficient planning of these regulatory approvals.
- Thirdly, the coinciding implementation deadlines for phases 2-4: even though the publication of the final requirements (via technical standards or guidelines) is spread over time, we are concerned about an over-concentration of regulatory approvals and subsequent implementation in the final stages of this timeline.
- Also, the length of the implementation periods: even disregarding the previous comments, 2 years for the implementation of the 3rd phase and 1 year for the 4th phase seem very short, as it is very likely that most, if not all, of institutions' rating systems will be impacted and require a thorough redevelopment.

- Finally, the entry into force of the RTS on assessment methodology of the IRB approach: while it is indicated that this methodology is applicable for competent authorities at the time of entry into force of the RTS, it is not clear when institutions will be expected to be compliant with these requirements. We would welcome further clarification by the EBA and competent authorities of the timeline for implementation of these changes. Moreover, the RTS on assessment methodology already touches upon several topics also covered in the later phases. We see serious practical objections if these topics are not aligned, as it would imply an even higher number of changes to the rating systems. Hence, we emphasize the need to align the entry into force of regulatory changes as much as possible to maximally limit the number of changes.

Additionally, we wish to note that a complete assessment of the reasonability of the timeframe is only possible when all regulatory developments are clarified and requirements are final.

Q4: Are there any other aspects related with the application of the definition of default that should be clarified in the GL?

No, we believe the most important aspects of the definition of default are mentioned. Of course, the consistency across institutions that will be achieved in the definition of default depends on the actual level of guidance and clarifications given in the guidelines.

Q5: Do you have experience with adjustments of historical data? What are the methods that you used to adjust historical data, including both internal and external data?

We have only limited and rather problematic experience with the adjustment of internal data. This was mostly done on an ad-hoc and best-effort basis. The main limitations encountered are:

- Adjusting historical data is very time demanding, typically requiring a huge amount of manual work.
- In many cases, not all information required to flag defaults according to the new definition is available for the full data history. This implies that workaround and/or expert judgement are to be used in the data adjustment.

- Moreover, it is possible that the behaviour/performance of a portfolio would have been different if the new definition had already been in place in the past. Again, expert judgement is needed to make this assessment.

The need for expert judgement and assumptions inevitably reduces the comparability across institutions. Because of these drawbacks, we recommend that retroactive adjustments of historical data are limited as much as possible.

Q6: To what extent is it possible to adjust your historical data to the proposed concept of materiality threshold for the purpose of calibration of risk estimates?

It is possible but would be very hard for the reasons mentioned in response to Q5.

Q7: What is the expected materiality of the changes in your IRB models that will result from the proposed clarifications as described in section 4.3.2?

The exact impact is impossible to predict at this moment, as this depends on further clarification of the proposals. However, we expect the number of resulting material changes to be very high, for PD, LGD as well as EAD models. Certainly the change to a number-weighted LGD/CCF would have a material impact. Therefore, it is essential that the proposed changes are maximally aligned, also with parallel BCBS developments, to avoid multiple subsequent changes.

Q8: Do you consider the direction of the proposed changes adequate to address the weaknesses and divergences in the models across institutions?

The general direction of the proposed changes seems adequate and supports EBA's intention to reduce the divergences between different institutions. For a complete assessment of the adequacy of the changes, we need to await the further clarification of the requirements and the degree of flexibility that will be left to allow for an accurate risk measurement. However, we deem certain specific proposals not to be appropriate to address the weaknesses in models:

- Number-weighted LGD/CCF: the rationale in favour of a number-weighted LGD/CCF is not clear to us and this approach seems contradictory to the use test of LGD/EAD models.

- The requirement that the estimated PD based on the reconstruction method should not be less conservative than the long-run average of one-year default rates estimated from the available data. If the available data on delinquency refer to a downturn period, and are not representative of a whole cycle as desired for PD estimation, it should be allowed to introduce a downward correction to the estimated PD.
- Finally, for some changes (e.g. downturn adjustment of LGD and CCF), it is too early to judge the adequacy as no concrete proposal is yet available.

Q9: Are there any other aspects related with the estimation of risk parameters that should be clarified in the EBA guidelines?

Further guidance on the following three topics would be welcome:

- LGD calibration methodology
- PD estimation: a clear description of the economic cycle to be used
- Back-testing procedures for risk parameters

Q10: Do you have dedicated LGD models for exposures in default that fulfil the requirements specified in section 4.3.4.(ii)?

In our opinion our LGD models for defaulted exposures are in line with the requirements described.

Q11: Do you consider the direction of the proposed changes adequate to address the weaknesses and divergences in the treatment of defaulted assets across institutions?

Yes, they address the right issues.

Q12: What else should be covered by the GL on the treatment of defaulted assets?

The GL on the treatment of defaulted assets could include following modelling related aspects which are not mentioned in the regulation, even though a different treatment on these topics may lead to different results.

- Firstly, the definition of cut off time in LGD modelling: as the recovery process is often quite long and a major part has to be taken into account to come to reasonable recoveries, this will result in the use of old data. Further guidance on this topic would be helpful and will avoid questioning of the models in the future.
- Secondly, more guidance would be welcome on the level on which the calibration has to be done. For retail exposures, two levels are possible: pool or portfolio level. In combination with the requirement that the average PD has to be equal to the calibration target, both approaches can result in different final RWA figures for a given portfolio.
- More guidance is needed about minimum cure periods and about the ratings to be assigned following recovery.

Q13: What are the impacts for the institutions that should be considered when specifying the conditions for PPU and roll-out?

We fully agree with the basic principle that the IRB approach has to be implemented for all exposures of an institution, with only a limited set of clearly-defined exceptions. It is the responsibility of each institution moving to an IRB approach to present a strict, but at the same time also realistic, roll out planning. A close monitoring of the roll-out period and the permanent exceptions remaining afterward is justified, in order to guarantee a level playing field and to prevent cherry picking. It is nevertheless necessary to maintain some flexibility, for example when characteristics of portfolios change over time, in situations such as mergers and acquisitions, or when additional regulatory requirements jeopardise the proposed timings.

Q14: Do you expect that your organisational structure and/or allocation of responsibilities will have to be changed as a result of the rules described in section 4.3.5?

It is impossible to properly judge at this moment whether changes will be required to the organizational structure and/or responsibilities. Further specification of the required level of separation of functions is needed as well as clarification of the proportionality principle to be applied in this respect. Also, more explanation is requested about the requirement that default rates and rating migrations under stress conditions should be taken into account in the PD estimation.

Q15: Do you agree that CRM is a low priority area as regards the regulatory developments?

Yes.

Q16: Are there any other significant intra-EU or global discrepancies?

Our main concern is rather that the proposed changes, while trying to increase intra-European harmonisation, could result in new, additional discrepancies with the global Basel framework. The risk exists that the Basel framework and the European implementation in the CRR, will further diverge. We think EBA and the BCBS (together with other international regulators) should first strive to harmonise international regulatory requirements as much as possible, followed thereafter by an accurate local implementation.

Additionally, future guidelines would be advisable to address situations where an international financial group is affected by divergent home and host supervision practices, in order to clarify what should be assumed locally and what at the consolidated level.

Q17: Do you agree that the area of disclosures needs to be strengthened, in particular with regard to disclosures related with the benchmarking exercise, for instance by publishing them on the EBA website?

We doubt whether there is a need for publication of additional disclosure, in particular very detailed information related to benchmarking exercise results (whether this be on the EBA website, the bank's own website or elsewhere). The potential of this disclosure to increase complexity and spread confusion should be carefully assessed. We note that the consultation of the current publicly available Pillar 3 report (which is already quite comprehensive) is very limited. Moreover, several stakeholders (e.g. rating agencies, regulators) already receive extensive information on the risk position of the bank. Other parties (e.g. general public, press) show only a limited interest in very detailed data.

Q18: Would you support EBA Guidelines targeted at disclosure requirements related with the IRB Approach and taking into consideration the proposals of the Basel Committee on those requirements? Which current disclosure requirements should be given the priority? What should be the timetable for such Guidelines?

We prefer that requirements are as much as possible globally aligned. It is our preference that changes are initiated by the Basel Committee and afterwards further implemented, and in certain cases further detailed, on a European level.

Q19: Would you like to see any modification of the reporting framework implemented in terms of IRB exposures?

The goal should be a maximum harmonisation of different reporting requirements.

The main principle should be that each reporting item should be asked only once. Currently, institutions are required to deliver several reporting templates containing approximately identical figures, each time for a slightly different scope or with a different breakdown (e.g. reporting on provisions/impairments in COREP to EBA; in FINREP, also for EBA; in the planned AnaCredit reporting to ECB, etc). If it is really necessary to ask things twice, we would like to see that the same definitions are used (preferably those of the CRR), the same scope and the same reporting date.

In general, for a qualitative reporting, we need

- Clear definitions of the concepts used;
- Requirements that are timely finalised, followed by sufficient time for implementation.

Q20: What would you consider an appropriate solution with regard to the definition and treatment (modelling restrictions) of the low default portfolios?

We would welcome a clearer and unambiguous definition of low default portfolios. As to the treatment of these portfolios, in our opinion no straightforward or ideal solution exists. An appropriate solution could be a “sophisticated standardized” approach, which is still sufficiently risk sensitive to incentivize good risk management by the institutions. Hereby, it is important that a level playing field across institutions is pursued.

Individual bank’s data should be considered rather than attempting to apply a one-size-fits-all approach.

Q21: How would you ensure appropriate use of the IRB Approach in a harmonised manner without excessive concerns of the so called ‘cherry picking’?

Our main concern here is the enforcement of a true level playing field for all institutions. When rules exist, they have to be implemented by all banks in the same way. Now, the existing general rule that the IRB approach should be rolled out to all portfolios (taken into account a clearly-defined roll out plan) seems to be implemented entirely differently from one institution to another. Then, further convergence in supervisory practices when approving roll-out plans would be beneficial to foster harmonisation..

A possible further solution could be to define more “minimal requirements” on the portfolios that can remain under the standardised approach.

Q22: Do you see merit in moving towards the harmonisation of the exposure classes for the purpose of the IRB and the Standardised Approach?

We are strongly in favour of a harmonisation of the exposure classes of both approaches.

The main arguments are of a practical nature. For banking groups with exposure under both approaches, the current discrepancy between the exposure classes results in an additional reporting burden, requires frequent (internal and external) clarifications to explain differences in categorisation, and makes comparisons difficult.

These concerns have increased by the recent publication by the Basel Committee of a proposal on the IRB floors. Under these proposals, an IRB floor will be constructed based on the standardised approach, which will oblige banks to make calculations under both approaches. Comparisons of capital requirements between both approaches will be highly unclear if exposure classes are not aligned.

In this respect, we prefer to move towards a uniform classification, based on the current IRB exposure classes. Under IRB, the limited number of major classes (sovereigns, institutions, corporates, retail,...) corresponds to the commonly used categories within the banking industry, which is not the case under the Standardised approach. For example, under the latter approach, the separate reporting of defaulted (past due) exposure, containing counterparties of several categories, seems very confusing.

This does not, however, prohibit that a specific weighting methodology, different from the general rule, has to be used for some exposures within one exposure class.

Q23: Would the requirement to use TTC approach in the rating systems lead to significant divergences with the internal risk management practices?

A TTC approach in PD modelling is already used and we believe that the TTC approach as part of parameter calibration is relevant for risk management purposes..

It has to be noted, however, that PIT modelling still has its importance in provisioning and is also required for IFRS 9. It is important that PIT estimates should continue to be permitted for prudential purposes since they have a legitimate role to play in risk management

Q24: Do you agree that the possibility to grant permission for the data waiver should be removed from the CRR?

We agree in principle, but believe that a limited possibility to use a data waiver under specific conditions should remain. For high default portfolios (such retail or SME), a two years historical data set could already contain sufficient meaningful information, more so than 5 years of history for low default portfolios. Therefore, for example new high default portfolios (new business lines or acquired portfolios), the use of a data waiver may be more appropriate than the Standardised Approach.

Also, we wish to emphasize that the length of the available data history strongly depends on the stability of requirements and definitions. If requirements are changed, retroactive adjustment of the data is needed, which can significantly decrease the amount of reliable historical data.

Finally, the presence of sufficient data for both downturn and upturn/normal years (allowing a full economic cycle to be constructed) seems more important than the total length of the available data history.

Nevertheless, consideration should also be given to the decision taken recently by the BCBS to remove selected national discretions, including the one related to granting permission for data waiver for corporate, sovereign, bank and retail exposures.

Q25: Are there any other aspects of the IRB Approach not discussed in this document that should be reviewed in order to enhance comparability of the risk estimates and capital requirements?

No.

1. Legend

CRM = Credit Risk Mitigation

GL = Guidelines

PPU = Permanent Partial Use

RTS = Regulatory Technical Standards

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Submitted on behalf of the EBA Banking Stakeholder Group

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