

Comments of
ITCB Consulting and Training Ltd.
regarding
CP10
of the Committee of European Banking
Supervisors (CEBS)



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GENERAL REMARKS

The ITCB welcomes the opportunity to comment the CP10 guidelines, which clarify the main components of the validation process.

While studying the guidelines we missed two areas that would require further clarification, and we would like to seize the opportunity to formulate two questions for CEBS:

- the question of provisions is still an open issue: that is what is the exact provision definition that shall be compared with EL; and how will the CRD requirements on calculating provision harmonize with IFRS rules;
- why is the ‘validation’ of credit risk mitigation techniques out of scope of CP10.

We hope that CEBS will soon give its opinion on these areas as well.

COMMENTS

Chapter 2: Co-operation procedures, approval and post-approval process

2.2.6. Transition period

1. Several countries will implement the CRD in the local regulation by end-2006 or later. It may cause problems and we feel so that there is still lot jurisprudence in the area. It should be clarified in more details:
 - a. what is the proposed way and timetable of the pre-application consultations in such a case;
 - b. in case of banking groups what is the way of validation if one of the subsidiaries cannot implement the IRB because the CRD will have not been implemented yet by that time in local regulation.

Chapter 3: Supervisor’s assessment of the application concerning the minimum requirements of the CRD – Credit Risk

3.1.1. Roll-out

2. In case of roll-out what is the proposed portion of the exposures to be covered by IRB in order to start the approval process? What if home and host supervisors set different levels for coverage?

3.1.2. Permanent partial use

3. The Consultation Paper says that “the term ‘business unit’ may refer to separate organizational or legal entities, business lines, or **delimitable homogeneous groups of exposures within a group**”. According to our reading this means that for example if private banking exposure is immaterial within the retail portfolio and the institution intends to



implement IRB on retail exposure class it is allowed to use standardised approach on private banking exposures permanently. Please notify whether this is the correct reading of this point.

3.2. Use test

Use of data for internal purposes

4. According to point 142 the use test of LGD and CF estimates is a key point in validation. In our reading the use test for these parameters is fulfilled if the institution establishes provision calculation that is based on risk parameter estimates that are broadly in line with minimum requirements.

Experience test

5. According to point 147 the experience test of own LGDs and conversion factors for non-retail exposures can be reduced to no less than two years if the credit institution applies for the use of own estimates of LGD and CF. Unfortunately there is no statement on the use test of LGD and CF estimates in case of retail exposures. As point 128 states the use requirement of rating systems can be reduced to one year. In our reading it follows that the use test of LGD and CF estimates may be reduced to one year as well in case of retail portfolios. This derogation should be stated accordingly.
6. What is the meaning of the 'good mix' and the 'use-test trade-off' in point 149?

3.3. Methodology and documentation

3.3.1. Assignment to exposure classes

3.3.1.1. Retail exposure class

3.3.1.1.1. Individual persons and SMEs

7. We would like to remark that the wording of point 159 is somewhat misleading. According to CP10, the requirement of treating SMEs less individually in the retail portfolio can be met if **any** of the mentioned credit process components differ clearly in case of SMEs. We don't think so that for example if the institution applies different marketing and sales activities for SMEs, but all other components is the same as for corporate exposures, then these SME exposures may be classified as retail exposures. However we must state that we agree with the intention of CEBS, that it shouldn't be required to differ in all mentioned components, but it should be clarified which components are the most critical ones in fulfilling this requirement.



3.3.2. Definition of loss and default

3.3.2.1. Definition of default

Definition of default within the same country

8. As result of the consultations with local institutions we must remark that certain problems may arise from the requirement that the definition of default within the same country shall be based on regulatory definition of default. It is not obvious on what basis national authorities shall formulate one definition, how the requirement on materiality shall be unified in different institutions and mainly across countries (in case of banking groups). Further clarification and consultation with market participants are required in this field.

3.3.3. Rating systems and risk quantification

3.3.3.2. Loss Given Default (LGD)

9. Please clarify the proper definition of ‘default-weighted average of realised LGDs’!
10. In our opinion taking into account incomplete workout cases when calculating LGD shall distort the final result. That’s why LGD models should not include incomplete cases, so we recommend deleting this requirement from CP10.
11. Please clarify in more details the ‘two step approach’ for computing LGD! (234-235)
12. In our reading if a credit institution has not been collecting indirect costs so far, and the level of indirect costs is deemed to be immaterial (our experience confirms this assumption), and the amount recovered from the collaterals fully covers the exposure owed, then the institution can calculate with 0% LGD. According to us in this case it is not required to adjust the recovery with the immaterial amount of indirect costs and calculate with eg. 1-2% LGD instead of 0%. Please notify whether this assumption is proper!

Chapter 4: Supervisor’s assessment of the application concerning the minimum requirements of the CRD – Operational risk

4.2.2. General and specific conditions for the use of ASA

13. According to the wording of point 425 ‘holding of a risky credit portfolio’ must be demonstrated by the credit institutions if they want to use ASA for operational risk. It requires further clarification whether the measurement of riskiness is based on probability of default, or default rate or other measure. In our opinion PD may not be a proper measure in case of a credit institution, which is going to implement standardised approach on credit risk, so clarification is necessary.