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CEBS - Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches (CP 10)

The Bank and Insurance Division of the Austrian Economic Chamber welcomes the opportunity to submit its opinion on the Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches consultation paper (CP10).

Principal statements

- The home - host principle leads to differences which are caused by partly deviating interpretation by national supervisory authorities. For example, despite the fact that two banks are comparable as regards size and complexity, differences with respect to application of the IRB approach exist due to deviating interpretation by two consolidating supervisors. It is therefore necessary that the guidelines described in detail in CP10 are interpreted by the supervisory authorities in a way that avoids distortion of competition which may be caused by application of the IRB approach.
- Since a large number of comprehensive guidelines and requirements already exist with respect to implementation of Basel II, the CP 10 should not contain requirements providing for possible additional requirements on the part of national supervisory authorities.

➤ Proportionality

The present consultation paper does not sufficiently take into account the size and structure of banks. In this respect clarifying notes should be included in CP10, in particular on outsourcing of systems to central units within a sector and assessment and/or inspection of these systems at such central unit. Responsibility for fulfilment of all requirements imposed by supervisory authorities and appropriate use of systems may, as a matter of fact, lie only with the (co-)using bank.

- Instead of increasing the number of requirements to be fulfilled (e.g., with respect to validation) emphasis should be laid on clarification and specification of vague and misleading wordings of the Directive.
- In any case it should be avoided that different official documents contain deviating regulations (CEBS-CP and CRD). For example, "Internal Governance" is the subject-matter of a separately regulated control system as described in CP 03. Additional independent regulations beyond that scope in the first pillar are not necessary at all (as described in CP 10).
- To some extent the degree of the prescribed details with respect to the application process seems too high. We are of the opinion that it would be more appropriate to formulate interim results and/or stages instead of regulating the individual steps, since such interim results and/or stages may be designed more individually.
- Furthermore, we do not think that requirements that are no longer contained in the draft Directive should now be given binding force by CP 10 (e.g., Paragraph 3.3.1.2.2, Specialised Lending, where reference is made to Paragraph 179 of the Basel II framework).
- We also point out that the detailed requirements contained in CP 10 do not allow the degree of flexibility banks need due to their different size, complexity and business strategy.

Comments in detail

Chapter 1: Introduction

1.3. Addressees/Scope of application

23:

As already mentioned CP 10 provides a comprehensive list of guidelines and requirements for the procedure to be used by supervisory authorities with respect to applications. This should cover all requirements to be expected by a banking group with respect to the application process.

Chapter 2 Cooperation procedures, approval and post approval process

2.2.1. Application

Documentation of rating systems

53:

We are of the opinion that the regulation requiring that documents and information that are not even specified in more detail are to be made available "upon request" goes too far. An exhaustive list of all documents and information necessary for approval of the application would therefore be desirable. In any case banks should be able to identify in advance which documents are subject to inspection by the supervisory authority and which are not.

2.2.1.1. Minimum Content

Documentation of rating systems

Self assessment

62-64:

Basically, we consider self-assessment of banks with respect to fulfilment of the minimum requirements set out in the CRD as expedient. However, due to the fact that the requirements regarding the documentation to be provided on such self-assessment could be interpreted in different ways we think that it would be appropriate for the supervisory authority to make available pre-defined forms for that purpose. If possible, such forms should be used EU-wide, or in case of differences, they should at least be recognised mutually. In order to avoid double work of the banks such self-assessment should be limited to that which is absolutely necessary. All information about the implementation status of the IRB in the different banks is anyhow contained in the requested documents.

2.2.1.3. The starting of the six-month period

69:

It is not clear how the phrase „...or is otherwise deemed incomplete...“ is to be interpreted. The scope of the authority's discretion is so wide (as in Paragraph 53) that banks are unable to know in advance whether they fulfil the formal requirements or not.

In our opinion the fact that an application is deemed incomplete may only refer to incompleteness with respect to documents that have been stated in advance and not to the supervisory authority's discretion as to whether an application is deemed "otherwise" incomplete. Accordingly, sentence three of Paragraph 69 should be abolished. Other types of incompleteness can, if at all, only exist during the phase of assessment. We also think that the exact point in time at which the six-month period starts to run should be specified in more detail.

2.2.2. Supervisor's Assessment

79:

With respect to independent formation of opinion we do not consider wise that supervisory authorities may use the bank's own resources and/or external resources of the bank in connection with assessment of the IRB application.

2.2.3. Decision and permission

84:

Regarding item c we would like to state that banks of course have to accept conditions imposed or recommendations made with respect to compliance-relevant issues in the decision of the supervisory authority on an approval to use IRB. We do, however, not think that it is necessary to include the passage "... suggestions for the possible improvement of any imperfections..." in the decision.

2.2.4. Change in the consolidating supervisor

88:

We welcome the provision contained in Paragraph 88 according to which a new approval process is not necessary after a change in the consolidating supervisor. However, modifications of the approval process after cross-border mergers and acquisitions are expressly allowed (here a reference to roll-out is made, Sections 3.1.1. and 4.3.1.). With respect to planning reliability and cost control a restriction on admissibility of such modifications of the approval procedure should be included in the relevant sentence ("However, cross border mergers...") in the event

that contents (such as, e.g., roll-out plans) have already been agreed in principle with the national supervisory authority by means of an advance consultation process. Such stipulations should continue to have binding effect also on a new consolidating supervisor. This refers to a type of merger that is not described in Paragraph 110.

Chapter 3 Supervisor's assessment of the application concerning the minimum requirements of the CRD - Credit Risk

3.1.1. Roll-out

99 ff.

As a matter of principle the different approaches should have equal status during IRB roll-outs.

104

Only the bank can decide, based on its business model, which parts of the portfolio will be rolled out first. Only a proposal for modification/condition can be made in this respect, but in no case can such a decision be taken for the bank. Accordingly, we would suggest a modification of Paragraph 104 in this sense.

107

In our view the fixing of a time horizon for the roll-out is questionable since the banks' business strategy is not taken into account.

109

We are of the opinion that in case of a change of the business strategy it would not be expedient to stick to the "same old" time horizons for roll-outs since in such a case the sequences must first be established and the prerequisites for fulfilment of the IRB criteria must be created gradually.

3.1.2. Permanent partial use

114

According to this Paragraph the absence of sufficient default data is a clear key determinant of whether the IRB approach can be adopted or not. However, in case of such a portfolio the *modus operandi* should consist in permanent partial use as laid down in the CRD. The choice to apply external data pooling should continue to lie with the banks. This should be expressly clarified in Paragraph 114.

3.2. Use Test

Experience Test

149

The use test consists in the requirement to fulfil the provisions of Article 84 (2b) (scope and use of data for internal purposes) and Article 84 (items 3 and 4) (experience test). The time limit expressly set with regard to implementation of an "experience test" must not implicitly be deemed a period for application of the "use test". This should be expressly stated in CP10.

3.3.1.1. Retail Exposure Class

3.3.1.1.1. Individual persons and SMEs

162

The practice of Austrian banks is not fully reflected in this Paragraph. An individual rating of a retail customer should not exclude classification of the same as belonging to the retail sector. In addition, it should be included that individual ratings of retail customers is allowed.

179

The sub-classes of "specialised lending" originally regulated in the Basel II framework were expressly excluded in the CRD.

3.3.2.1. Definition of Default

Default of individual entities vs. default of groups

197

The term "consistent" used in this Paragraph should be defined in detail.

Rating: A group rating may under certain conditions (e.g., liability) be assigned to an individual group company. This means that within a group of banks the rating will be made top-down (if appropriate with regard to credit rating).

Default: A group of companies (=no legal entity) cannot be in default, but only the companies belonging to it. It has not been clarified yet whether default of one subsidiary means that all companies belonging to the same group are in default. As the case may be, default of a subsidiary could result in default of the entire group (this would mean an automatic bottom-up effect of default); this would lead to far-reaching financial consequences. However, such "passing on" should not be determined generally because there may not always be economic reasons.

Furthermore, it is not clear how to interpret „...legally bankruptcy remote...“ in this connection, i.e. what criteria justify separate treatment of parent and subsidiary.

3.3.3. Rating systems and risk quantification

When describing the requirements to be fulfilled by rating systems, CP 10 primarily uses statistical systems; only with respect to low-default segments reference to expert systems is briefly made. However, in practice this is not always the case; also in segments with a large number of customers expert systems are being used due to the fact that some banks do not want to assess their customers according to statistical criteria only but also want to take into consideration a subjective/qualitative evaluation of the customer's ability to repay loans (normally such assessment is made by an experienced corporate analyst). This means that expert systems are, for example, also used in segments with corporate customers and are not necessarily deemed a "beginner's system" only, which is used until a statistical system has been developed. According to the draft directive/IRB approach both types of systems, i.e., statistical systems and expert systems, are admissible.

Such expert systems are not sufficiently taken account of in the present consultation paper. It would be necessary to include guidelines, e.g., for validation of expert systems, which could help both supervisory authorities and banks to orientate themselves.

3.3.3.1. Probability of Default - PD Estimation Methodology and

3.5.3 Low-default-portfolios

These Paragraphs only set forth the criteria applied with respect to disclosure. Admissible procedures that can be applied for assessment of the PDs are not referred to. Also in this connection more detailed guidelines for supervisory authorities and banks should be included since otherwise merely subjective criteria of the relevant supervisory authority in charge will be applied for validation of a method.

Also in case of low-default portfolios admissible procedures for determining PD should be stated. It is not sufficient to refer to "adequate margins of conservatism" (Paragraph 349) or the requirement of a "use test" (Paragraph 351) only. In the event that no reliable calculation methodologies or estimation methodologies are stated, groups of bank operating in several Member States run the risk that individual methodologies may be recognised in one Member State but not in others.

3.5.2. Validation tools: Benchmarking and Backtesting

335ff

According to Paragraph 335ff, benchmarking with external data is required for the purpose of ensuring consistency of the IRB risk quantification.

Use of external data for benchmarking in order to ensure consistency of the rating system is problematic since it is not possible to ascertain without further ado whether resulting differences between the rating system and the benchmark are caused by the internal rating system or the system generating the result of the benchmarking. In order to be able to identify the reason for such differences without any doubts validation of the external system would be necessary which, however, banks are not able to carry out. We therefore think that benchmark analyses should only be carried out voluntarily, i.e. that the banks should be granted the option to choose whether to carry out a benchmark analysis or not. If, however, a mandatory benchmark analysis will be required the bank's obligation should, due to lack of information value of the benchmark analysis, be limited to the documentation and no binding conclusion should be drawn with respect to validation on the basis of the analysis.

337

The concept of „higher margin of conservatism“ should be defined in more detail.

3.3.5. Low-default portfolios

352

In the case of a limited dataset for validation CP 10 speaks of so-called low-default portfolios (cf. Paragraph 348). However, Paragraph 352 contrariwise requires validation of these low-default portfolios. Accordingly, Paragraph 352 should be deleted without replacement.

Yours sincerely

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