CONSULTATION ON EBA/CP/2014/10 ON
DRAFT REGULATORY TECHNICAL STANDARDS ON THE SEQUENTIAL
IMPLEMENTATION OF THE IRB APPROACH AND PERMANENT
PARTIAL USE UNDER ARTICLES 148(6), 150(3) AND 152(5) OF
REGULATION (EU) NO 575/2013 (CAPITAL REQUIREMENTS
REGULATION – CRR)

General Comments
and Replies to Questions

BY THE EBA BANKING STAKEHOLDER GROUP
Foreword

The EBA Banking Stakeholder Group (BSG) welcomes the opportunity to comment on the Consultation Paper EBA/CP/2014/10 Draft regulatory technical standards on the IRB Approach and permanent partial use under the Standardised Approach under Articles 148(6), 150(3) and 152(5) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR).

This response has been prepared on the basis of comments circulated and shared among the BSG members and the BSG’s Technical Working Group on Capital and Risk Analysis.

As in the past, the BSG supports an initiative that aims at harmonizing supervisory rules and practices across Europe, in order to ensure fair conditions of competition between institutions and more efficiency for cross-border groups. However, the BSG identifies a number of issues which, unless properly addressed, could lead to unintended results.

General comments

The Banking Stakeholder Group welcomes this opportunity to comment on EBA’s draft Technical Standards and would like to draw attention to some general comments (this section), before addressing the specific queries included in the Consultative Paper. Whilst welcoming the document, the BSG has several reservations with respect to parts of the draft RTS.

The BSG recognizes the rationale of determining if a particular exposure in an exposure class is material or not in relation to the total credit risk exposure of an institution. However, in Article 150 of the regulation legal basis can only be found for quantitative measures for the number of material counterparties and qualitative measures for determining if the development of a rating system is unreasonably burdensome. The lack of legal basis for quantitative measures on exposure amounts suggested for Article 2 disqualifies the introduction of the suggested conditions. Hence, Article 2.1 (a) and (b) should be removed from the RTS.

When determining the threshold for the number of material counterparties, the ability to model and validate internal models should be considered. The number suggested in the draft RTS of 20 is
likely to require the IRB institution to rely heavily on external data and/or modeling techniques based on loose assumptions and qualitative assessment of a model’s predictive and discriminatory power. In the light of the scarcity of default observations, the accuracy of the model would be difficult to establish and annual validation would thus be more dependent upon a qualitative assessment methodology.

We understand that national regulations can only be applied after the entry into force in areas where there is explicit national discretion in the RTS. From our point of view this calls for a grandfathering clause. In particular, it would be disproportionate if institutions that are already applying the IRBA would be denied the opportunity of applying it because of stricter requirements in the RTS. Institutions that fail to comply with the new standards should at least be given enough time to adapt to the new regulations.

**Replies to Questions**

**Q1. Do you agree with the proposed draft RTS regarding the sequential application of the IRB Approach?**

The BSG is of the opinion that a sequential roll-out of an IRB system should be prioritized based on the actual effect on accurate risk measurement. This would then be reflected in the availability of risk data and outcome data available for internal model development purposes. Most typically the exposure classes Retail and Corporate would contain exposures where the availability of good quality data of sufficient size to support statistically sound model development and validation. Hence these exposure classes should be prioritized in an IRB roll-out plan. When considering other exposure classes where sufficient data generally is less prevalent, the probability of developing a rating system where the effect of a rating system on the quality and accuracy of risk measurement is lower should have lower priority.

Having said the above, the BSG recognizes the need to also consider a minimum threshold on total exposure and agrees with the proposition in Article 4(2) (a) of the draft RTS of a 50% threshold. This threshold, and a qualitative assessment of the institution’s ability to produce valid risk models for a specific exposure class, should provide sufficient information to establish a roll-out plan.

**Q2. Do you agree with the proposed draft RTS regarding permanent partial use of the Standardised Approach (SA) for the exposures specified in Article 150(1)(a) and (b) of the CRR?**
The BSG recognizes the rationale of determining if a specific exposure in an exposure class is material or not in relation to the total credit risk exposure of an institution. However, in Article 150 of the regulation legal basis can only be found for quantitative measures for the number of material counterparties and qualitative measures for determining if the development of a rating system is unreasonably burdensome. The lack of legal basis for quantitative measures on exposure amounts suggested for Article 2 disqualifies the introduction of the suggested conditions. Hence, Article 2.1 (a) and (b) should be removed from the RTS.

The number suggested in the draft RTS of 20 is likely to require the IRB institution to rely on external data and/or modeling techniques based on loose assumptions and qualitative assessment of a models’ discriminatory power. Annual validation would be even more dependent upon qualitative assessment methodology. Hence, the accuracy of the model would be difficult to establish. The BSG suggest the threshold value 100 to be used instead of 20. Generally, threshold that is too low could also have the unintended effect of “modeling for the sake of modeling” rather than for efficient risk management purposes. Furthermore, considering that the regulation states both that the number of counterparties should be immaterial and that it should not be unduly burdensome, more weight should be given to the qualitative condition the closer the institution is to the counterparty threshold.

Q3. Do you agree with the proposed draft RTS regarding permanent partial use of the SA for the exposures specified in Article 150(1)(c) of the CRR? Which of the two alternative proposals presented in the impact assessment section under ‘Technical options considered’ do you prefer?

The BSG is of the opinion that the overall 8% limit on total exposure proposed in 3(a) is overly strict and should be set at 15%.

In addition, we would like to point out that the marginal costs of rolling out the IRBA increase with the number of portfolios covered. This is due to the fact that the portfolios to be covered are becoming increasingly smaller and rating systems are more and more specialised. It can therefore be justified from both a risk management and an economic perspective to establish an opening clause to further raise the ceiling. This option should be granted if the bank can convincingly demonstrate to its supervisors that it would be unduly burdensome to roll out the IRBA to further portfolios. For this purpose the “unduly burdensome” considerations contained in Article 2 (2) could be applied. Furthermore, the choice between Standardized Approach and the IRBA should not be based on considerations of capital arbitrage.
Concerning the ceiling proposed in Article 3, we hold the view that the maximum ratio should reflect the share of exposures an institution is not treating with internal rating systems in those exposures for which the capital requirements can, in principle, be calculated using internal rating systems. In most cases it is therefore correct to look at the share of “relevant exposures” treated under the Standardized Approach in all “relevant exposures”. Regarding the definition of “relevant exposures” we nevertheless feel that certain adjustments should be made in order to capture the share of exposures that are not treated with internal rating systems correctly and to provide incentives to treat as many portfolios as possible under the internal rating systems.

**Exposures that should be eligible as “relevant exposures”**

In principle, it is reasonable to exempt equity exposures from the “relevant exposures” as for this exposure class a simple method for the calculation of risk weighted exposure amounts exists that is not based on internal assessments. However, this has the effect that the use of internal methods for the calculation of capital requirements for equity exposures (PD/LGD- or Model-Approach) does not affect the maximum ratio. In order to give institutions an incentive to use internal methods they should be allowed to count equity exposures for which the capital requirements have been calculated using internal methods as “relevant exposures”. Alternatively the 8% ceiling could be raised as proposed in point 2 of proposal 2 (page 21).

It appears to be adequate, in principle, not to count exposures to institutions belonging to the same group or institutional protection scheme as a “relevant exposures” if an institution has exempted these exposures from the IRBA according to Art. 150 (1) (e) or (f). Banks often apply internal rating systems to these exposures for which they have obtained supervisory approval. However, they do not use the REA determined with this system for the calculation of capital requirements because the treatment under the Standardized Approach (rather than the REA) better reflects the true amount of risk involved in these exposures. Due to the minimum PD of 0.03 percent and a supervisory LGD of 45 percent they would have to apply a risk weight of approximately 15 percent. In order to honour the use of such supervisory approved ratings systems it should be allowed to count these exposures among the relevant IRBA exposures.

**Exposures that should not be counted among the “relevant exposures”**

For securitizations, capital requirements are usually not calculated using internal rating systems. Except for the Internal Assessment Approach (IAA), the differentiation between Standardized Approach and IRBA exposures is based on the approach that is used for the predominant part of the securitised exposures (Art. 109 CRR). Ironically enough, in either approach risk weights for
securitisation exposures are often determined using external ratings. For this reason the use of Standardized Approach exposures in the numerator of the maximum ratio is not a reliable indicator for the share of securitisations an institution treats with internal rating systems. Therefore securitisations should be exempted from the “relevant exposures” altogether.

Expiring business units, (i.e. business units where no new loans are extended), should also be exempted from the “relevant exposures”. From our point of view it would be completely disproportionate if internal rating systems would have to be developed for these units. At least those units should be exempted where no new business has emerged after the implementation of the CRR.

In some countries promotional banks are organized as legally dependent but economically and organizationally self-contained units of merchant banks. They are acting on a non-competitive, not for profit basis in order to promote public policy objectives of their respective owners. Their liabilities are completely guaranteed by their owners. Their business and the exposures and liabilities resulting therefrom are completely separated from those of the merchant banks. Due to the simplicity of their business model, promotional banks apply the Standardized Approach. The application of the IRBA for these institutions would not only be uneconomic, it would be partly impossible due to regulatory requirements. This especially holds true for the case of extending promotional loans, where they have to apply the economic policy standards of their owners. Thus the “use test” required by the CRR cannot be fulfilled if it comes to using the internal rating in the process of credit granting. Consequently, it should be possible to exempt the exposures of the promotional bank from the “relevant exposures”.

From our point of view it is currently not clear whether exposures to CCPs to which a risk weight of 2 percent is applied according to Art. 306 (1) (a) CRR have to be treated under the Standardized Approach or the IRBA. A respective Q & A has not been answered yet. In case they are to be treated under the Standardized Approach, they should be exempted from the “relevant exposures” as well.

Concerning the proposal for the treatment of CIUs, we understand that the underlying non-equity exposures of a CIU should be regarded as “relevant exposures”. Non-equity exposures which banks treat under the Standardized Approach according to Art. 150 (2) (b) would thus have to be accounted for in the numerator of the maximum ratio. We reject this and recommend to exempt CIUs from the “relevant exposures” altogether.
Concerning the technical options, considered the BSG favors Proposal number 2 since it is not based on a comparison based risk-weights calculated using the SA and allows the competent authorities to conduct a qualitative assessment on an institute by institute basis.

Q4. Do you agree with the quantitative thresholds proposed in Articles 2(1), 3 and 4(2) of these draft RTS? If not, what thresholds do you consider more suitable?

For the reasons stated in question 2 above, the BSG is of the opinion that the proposed thresholds in Article 2.1 (a) and (b) should be removed, and Article 2.1 (c) should be changed to 100.

The BSG is of the opinion that the overall 8% limit on total exposure proposed in 3(a) is overly strict and should be set at 15%. Given that there are variations in the application of the Standardised Approach between institutions regarding risk-weight estimation, a threshold based on risk-weighted exposure amounts would risk to introduce unwanted bias in the assessment. Hence Article 3(b) should be deleted.

Q5. Do you think that separate quantitative thresholds should apply for application of these draft RTS on an individual and on a consolidated basis? Which of the two alternative proposals presented in the impact assessment section under ‘Technical options considered’ do you prefer?

It is the opinion of the BSG to have the thresholds apply on a consolidated level in order not to have the operational set-up of a financial group influence the development and roll-out of an IRB system, rather than the actual risk profile of the group as a whole.

With regards to the proposals put forward under ‘Technical options’, the BSG favors Proposal 2.

Q6. Do you agree with our analysis of the impact of the proposals in this Consultation Paper? If not, can you provide any evidence or data that would explain why you disagree or which might assist our analysis of the possible impact of the proposal?

The BSG is of the opinion that consideration of the likelihood of developing internal models with high accuracy and sufficient data for model validation should be reflected to a larger extent in the RTS. To force institutions to develop rating systems where the accuracy of internal credit risk models is difficult to assess using quantitative methodology does not necessarily increase the quality of capital requirement calculations, rather the opposite.
Submitted on behalf of the EBA Banking Stakeholder Group

David T Llewellyn

Chairperson, EBA Banking Stakeholder Group