

Comments

on the EBA consultation paper "On assessment methodology for IRB approach" (EBA/CP/2014/36)

Register of Interest Representatives
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Comments on the EBA consultation paper "On assessment methodology for IRB approach" (EBA/CP/2014/36)

On 2 November 2014 the European Banking Authority (EBA) published the consultation paper "On assessment methodology for IRB approach". We welcome this opportunity to express our opinion.

I. General remarks

We expressly support the aim of the RTS draft of improving the consistency and comparability of capital requirements through a harmonized approval and assessment practice for internal models. This support also applies for the IRBA-related measures aimed at reducing outcome variability and equalising competition conditions. This is in our opinion absolutely necessary for ensuring model application in pillar I in the future.

The consistent application of existing CRR rules is of particular significance here. There are already comprehensive IRBA approval requirements which include improved minimum standards. In our view, the even more comprehensive RTS draft goes well beyond what is needed for the consistent application of the rules. It actually creates new requirements itself, such as additional minimum organisational standards which would seriously impinge on the running of our institutions, even though these already take into consideration the EBA's objectives such as independence and thus the objectivity of the validation within their organisations. We strongly doubt whether the legal basis in Art. 144, 173 and 180 allows for this and therefore strongly opposes minimum organisational standards that go beyond the CRR requirements. Here, consistency with the CRR requirements must be ensured.

Additional requirements in the RTS draft arise in part from CEBS Guidelines 10, which are being replaced by this RTS draft. Those guidelines were not legally binding, however, whereas the additional requirements in the new RTS draft would be. This RTS draft also has overlaps with the recently consulted regulatory standards on materiality thresholds for determining payment default for the IRBA default definition and on the technical standard on model changes. Here too, it must be ensured that consistent requirements are issued.

We also have our doubts above all about the consultation paper's proposals on the organisation of institutions that relate to validation. We see problems above all concerning the IRBA procedures widespread in Germany that are developed jointly on the basis of consolidated data (pool models).

The core idea of pool models is the merging of data from individual institutions into a common data pool. That data pool then forms the basis for developing a common rating model. As a rule, the technical rating application is operated centrally. Institutions apply the same algorithm and the same input stipulations. The participating institutions receive comprehensive documentation of the modelling, especially the rating algorithm and the technical implementation and also application guidelines so as to ensure uniform use. The common rating procedure and its further development are validated by a central outsourcing unit (pool provider) at the pool level on the basis of all the participating institutions' data. The expertise of the participating institutions is also leveraged. In order to ensure risk-appropriate modelling and workable process specifications, individual institutions are intensively involved in further enhancements. All the decisions, for example on changing the rating procedure, are made by the participating banks jointly on the basis of transparent documentation and clearly defined decision rules.

The pool provider provides institutions with statistical analyses of their portfolios so that the validation results at the pool level and the reasonableness of the rating results at the institution level can be made plausible. Institutions use those analyses to carry out their own internal validations. This validation

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addresses above all the representativeness of the data and compares the default probabilities with the actual default rates (back testing) for the institution's own portfolio. Thus, full heed is given to the demands on the use of pooled data in Art. 179(2) CRR.

The pooling of data enables institutions to use differentiated models even in those areas in which they themselves have only a small exposure portfolio or in which they have little default experience due to low default rates. In portfolio segments with little default experience ("low default portfolios"), even many larger institutions are only able to make sufficiently accurate forecasts about future defaults thanks to this modelling on the basis of a shared data pool. Smaller institutions in Germany in particular lack the data volumes necessary for developing statistically valid models, so that for them the development of rating procedures is possible only together with other institutions. These institutions profit especially from the know-how transferred during the joint development.

As already stated, pool models offer major benefits concerning the quality of data and forecasts. Furthermore, the large data volume in the pool enables the evaluation of differentiated and segmented pool models and their parameterization with sufficient accuracy. Within individual procedures it is also possible to identify additional risk drivers which would not have been identified as being significant on the basis of individual institutions' data. Pool models thus have a better forecasting quality, as the possibilities for identifying default-causing risk factors improve with the increasing size of the data pool. At the same time, there is an appreciable reduction in uncertainty in the modelling.

In essence pool models also meet the overarching regulatory goal, in that they significantly reduce the variability of the possible models and give greater weight to statistical validation.

In addition, the involvement of the pool provider and other participants pushes the particular interests of institutions into the background and reduces their individual scope of action: validations and improvements are generally made or prepared by the pool provider and this makes the decisions taken jointly by the pool participants more objective.

For the supervisory bodies too pool solutions offer a large number of advantages, as changes to the central modelling only have to be assessed once, the pool provider at the heart of the system is a competent point of contact and there is always up-to-date and professional documentation due to the large circle of addressees. A pool solution paves the way to uniform and fair treatment among institutions, even in segments with low default figures ("low default portfolios"). The variability in the capital requirements is reduced.

Moreover, pool models offer an opportunity to increase data quality through the introduction of a data quality assurance process as part of the data pool approach. In actual fact, there is also a disciplining effect which is reflected in the movement of various quality indicators. These include, for example, the timely updating of the rating, the reduction of uncontrolled overrides and the completeness of the default capture. This is especially beneficial for institutions using the standardised credit risk approach, as the procedures also have to comply with the stricter requirements for IRBA institutions concerning data and process quality and representativeness.

In addition, pool models offer process and cost efficiency advantages. The uniform professional IT implementation in pool models saves costs compared with individual solutions. The bundling of resources for maintaining and improving the pool models in central units generates process and cost advantages, too. The application of pool models also permits efficient reporting. Last but not least, the central

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outsourcing unit always produces a professional and up-to-date documentation of all the rating systems. The central bundling of expertise ensures the long-term availability of know-how.

The prohibition in Art. 4(3) of cooperation between model developers and model validators outsourcing arrangements effectively puts a stop to the pool solutions widespread in Germany, see especially our response to question 2. De facto the provisions in CRR Art. 179(2) and Art. 190(3)(a)-(e) are rendered null and void by the RTS draft and the large number of advantages offered by pool models for institutions will no longer be available for the supervisory bodies. The new provisions in the RTS draft should not, we believe, lead to proven pool solutions no longer being possible in practice.

II. Particular remarks

Q1: What views do you have on nature and appropriateness of the proportionality principle in Article 1(2)?

In principle, we consider the proportionality principle reasonable and necessary so as not to unnecessarily burden smaller institutions that have a comparably simple business model and low risk transactions. However, against the background of the ambiguous wording in Art. 1(2), it should be ensured that the fundamental methods defined in the pertinent chapters which the competent supervisory bodies have to apply ("competent authorities shall apply the methods defined in each chapter") already have to be based on the proportionality principle. The wording also suggests that solely additional methods ("apply additional methods") are based on this fundamental EU legal principle. At the same time, the wording creates the impression that the RTS draft is a minimum standard which can be extended by the pertinent supervisory bodies. This opens a door in our opinion to arbitrariness based on a subjective assessment.

We also have concerns over the concrete form of the proportionality principle, as pursuant to letter b the complexity of the rating models in particular is to be taken into consideration when deciding additional methods for assessing institutions' compliance with the IRBA requirements. The institution-specific rating models are – also in their complexity – all approved by the competent supervisory bodies, and hence we fail to see why such a fact already accepted by the supervisory bodies should lead to greater examination effort on the part of the institutions.

The proportionality principle seems to be extremely important for the application of pool models, too. Pool models also enable smaller portfolios of individual institutions to be assessed using advanced, complex and statistically validated models, which can be statistically validated more robustly thanks to the larger data pool. These procedures have a higher forecast quality. The proportionality principle should thus not bar the use of sophisticated rating procedures due to participation in pool models nor place greater assessment requirements on the tried and trusted methodology.

Q2: Do you agree with the required independence of the validation function in Article 4(3) and Article 10? How would these requirements influence your validation function and your governance in general?

In principle, we support the proposal concerning an independent validation function. We too attach great importance to the validation function's independence. It should be prevented, however, that this results in requirements being imposed that go beyond what is necessary for ensuring that independence. The conflicts of interest between model development and validation strike us being significantly less than, for example, between lending and risk controlling. Possible conflicts of interest are moreover minimized by

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the fact that for years institutions have been using validation concepts and internal control systems whose compliance is regularly reviewed by their internal audit departments and the supervisory bodies.

The independence of the validation unit from the personnel and management functions responsible for originating or renewing exposures called for in Art. 10(1)(a) is governed in Art. 190 CRR via the duties and responsibilities of the credit risk control unit. This independence from personnel and management functions responsible for originating or renewing exposures is already procedurally anchored at the institutions and hence enjoys our support.

An organisational separation of the credit risk control unit and validation function up to the "senior management" level is in our opinion not meaningful, as CRR Art. 144(c), 189, 190(2)(e), (f), (h) already makes the credit risk control unit responsible for key parts of the validation (especially responsibility for the rating models, reviewing the models (including the rating criteria) for their meaningfulness, active participation in the validation, reporting on the models' performance to senior management). For the validation function this only leaves the reviewing of the correct conducting of the validation or duplication of what the credit risk monitoring function has already done. Both functions (credit risk monitoring with respect to the model development function and the validation function) have the same interest ("valid models").

Moreover, it is for us indispensable and also required under Art. 190(1) and (2) CRR that the credit risk control unit be involved in designing and implementing and also in validating and changing models. This unit houses at great expense the necessary expertise not only for developing risk-appropriate and economically meaningful procedures but also for being able to judge the functional efficiency of those models. The credit risk control unit is familiar with the difficulties of daily application and is accountable for the modelling towards other units within its institution. It remains questionable whether this special expertise can be installed in a second unit in view of the quite limited scope of the validation function and the difficulties in recruiting highly qualified personnel for a very restricted, and hence somewhat unattractive, validation function. In our opinion, validation cannot be carried out without knowledge of model development. Moreover, validation generates insights which can be leveraged for developing procedures. That the validation function is involved in the entire process does not mean, however, that it cannot maintain its independence. This applies not only for the validation function within institutions, but also for validation by a central unit as part of the pool models common in Germany. We fail to grasp why this accumulated knowledge is being ignored in the new RTS draft; see for example CEBS Guidelines on Validation of 2006, para. 419 on the basis of the identically worded CRD I.

We support the requirement in Art. 10(1)(b)(i) RTS draft that the validation function must have adequate resources at its disposal to perform its tasks. Likewise, we regard the anchoring of a decision-making process as called for in Art. 10(1)(c) as necessary. Only this can ensure that the validation function's conclusions, findings and recommendations are promptly incorporated by the senior management in an appropriate manner. It is equally important, in our view, that the validation unit's recommended actions and stipulations cannot be interfered with in the interests of other units. It goes without saying that there should be regular internal auditing of compliance with the aforementioned points. We also support the separation of validation, model development and credit risk control staff addressed in Art. 10(1)(d)(i).

A further separation of the validation function from credit risk control, depending on the size of the bank up to the senior management level, is rejected for the reasons given above. The requirements in the RTS draft also go far beyond the requirements for internal models to calculate own funds requirements (see Art. 369(1) CRR); the demands on internal validation arise quite clearly from this source. There is no distinction between global or system-relevant institutions and those which are not. In our opinion, the

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organisational anchoring of the validation function should be independent of the size of the bank and gauged using criteria that are oriented on the goal of objective validation decisions and not on formal organisation structures. The proportionality principle should apply as an overarching approach and not be embodied as a detailed clause. In the pool solutions common in Germany, the participation of the pool provider on the one hand and the other pool participants on the other hand ensures a high degree of independence and objectivity, vested departmental interests are relegated to the sidelines and individual scope of action reduced: validations and enhancements are undertaken or prepared by the pool provider. This forms the basis for decisions to be taken by the pool participants using clearly defined decision rules. This ensures objectivity.

As already mentioned in the general remarks, many banks in Germany use internal rating systems that are based on "pool solutions". These solutions entail, inter alia, the outsourcing of the development, improvement and day-to-day running of the rating procedures. At least for pool providers, a special provision should apply here, as it is not clear how an institution can satisfy the requirement of CRR Art. 190(2)(f), if it has outsourced development of the rating system as a key task of the credit risk control unit and Art. 4(3) RTS draft does not permit the outsourcing unit to be involved in the validation unit's activities. If credit risk control unit tasks have been outsourced to an external service provider, it should also be possible for that external service provider to carry out the credit risk control unit's tasks under CRR Art. 190(2)(f) ("active participation in the [...] validation of the [...] models used"). Without recourse to the shared data pool and the pool provider's know-how, key advantages of data pooling will be lost and statistically precise validation forecasts are often not possible from the limited institution portfolios. Process and data quality problems frequently only emerge after a comparison of the institution's data with a larger data pool. In addition, pool providers already offer a high degree of independence through the organisational separation itself and the participation of several institutions. Apart from that, the requirement in Art. 4(3) RTS draft contradicts the possible outsourcing in the case of pooled data pursuant to CRR Art. 190(3)(a)-(e), which accounts for a significant part of the validation activities.

Therefore, Art. 4(3) should not apply for pool providers, so as not to stymie the provisions in CRR Art. 179(2) and CRR Art. 190(3). The demands on the validation function's independence pursuant to Art. 10 should apply regardless of whether tasks are outsourced or not.

Under Art. 4(3) a "third party" may not be involved in validation function activities, in so far as it is involved in the development and the risk quantification. In our opinion, this requirement goes clearly and inexplicably beyond the requirements for model development and model validation within an institution. If credit risk control unit tasks have been outsourced to an external service provider, it should also be possible for that external service provider to carry out the credit risk control unit's tasks under CRR Art. 190(2)(f). We therefore regard this requirement as unreasonable and would ask that it be deleted or suggest that the "third party" may be allowed to participate in, but not be responsible for, validation.

From our perspective, the external third party is per se functionally and organisationally independent of the model-using banks: the outsourcing as such entails a form of "independence" and organisational separation, in the sense of a separation from the outsourcer. The institutions must ensure that the separation of tasks is implemented and that no conflicts of interest whatsoever can arise by suitably controlling the outsourcing company. Moreover, the high standards of the objective assessment by third parties are already being ensured today through the aforementioned review mechanisms.

Furthermore, the term "third party vendor" used in Art. 4 needs to be explained more precisely. This should, we believe, cover providers which have full method sovereignty for the development and

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validation of the IRBA procedures and which can also decide model changes completely independently. In this sense, pool providers in Germany would not be "third party vendors", because those providers typically decide all the methodology issues on the basis of the pool-participating banks' clearly defined decision rules. The pool provider as a service provider always adopts a neutral, independent position.

Art. 4(2)(a) does not allow institutions to outsource areas other than those explicitly permitted under relevant legislation. We request that the word "explicitly" be deleted, as there is rarely explicit permission at both the European and the national level. In particular, for example, the outsourcing of IT implementation, operating rating systems at a central computer centre or entrusting auditing to an external auditor are not stated even though all of this is common practice.

Furthermore, it should be clarified that outsourcing within a company group does not count as outsourcing to a "third party" and hence fewer requirements need apply. This is the case especially for the ongoing review and alterations of models (Art. 190(1)(h) CRR).

The prohibition in Art. 4(3) of cooperation between model developers and model validators under outsourcing arrangements renders pool solutions common in Germany practically infeasible, especially as it is not clear how an institution can satisfy the requirement of CRR Art. 190(2)(f) CRR, if it has outsourced the development of the rating system as a key task of the credit risk control unit and Art. 4(3) RTS draft does not permit the outsourcing unit to be involved in the validation unit's activities. The provisions in CRR Art. 179(2) and Art. 190(3)(a)-(e) are de facto rendered null and void by these clauses and the large number of advantages for institutions and supervisory bodies alike can no longer be used, see the opening comments.

Having to forego pool-rating procedures would have a huge impact on the institutions affected: massive adjustments to the IRB systems and for each individual institution's organisational structures would be necessary (especially installing resources for permanent local model development and validation). It remains unclear whether the validity of an individual institution's models can be shown in the long run without recourse to the shared data pool (as the starting point of shared modelling). The outcome of this loss of pool models would under no circumstances be more but rather less objectivity.

The independence demanded for large banks up to the senior management level is in principle not workable. It would necessarily entail, however, not only a massive adjustment of the organisation structures but also a duplication of activities, without an iota of additional objectivity. Here, we believe there should be no overshooting of the goal, particularly as the conflicts of interest in conjunction with model development and its validation are clearly smaller than, for example, for the organisational separation between front and back offices.

In any case, such a rigid organisational separation would clearly delay the implementation processes.

Q3: Are the provisions introduced in Article 49(3) on the calculation of the long-run average of one-year default rates sufficiently clear? Are there aspects which need to be elaborated further?

Art. 49 Method of PD estimation

Having studied the requirements, we assume that both TTC and also PIT procedures can in principle be approved by the supervisory bodies, but would like corresponding clarification. PIT procedures are useful when it comes to ensuring precise and timely risk assessment. Nor is there any call for reducing modelling practices, as most banks operate hybrid systems, pure PIT or TTC systems are in our

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experience the exception. In addition, the EBA also concedes that there are no signs of procyclicality due to internal rating procedures (EBA, 2013, Summary Report on comparability and procyclicality, p. 29).

The "reconstruction method" mentioned in the box on page 77 should not be made obligatory, in our opinion. Whether this proxy approach ultimately shows valid empirical results is, in our opinion, not yet clear at the moment due to the lack of experience with this approach.

The PD estimation ought to be determined on the basis of a long-run average of the "one-year default rates". It should cover a period which is representative for the probable variability in that type of exposures in a complete economic cycle (Art. 49(2) RTS draft).

If an institution does not have sufficient data, it will have to conservatively estimate the missing default rates. This estimate may not lead to lower default rates than those actually observed (Art. 49(3) RTS draft). Alternatively, the default probabilities (estimated on the basis of too short a time series) can be "conservatively adjusted".

Here we must point out that only a limited number of years of default data are available for developing new procedures as a rule. The RTS draft requirements would always lead to there being a distorted parameterization of the rating procedures after a longer crisis. A different approach should be possible here in justified exceptional cases.

CRR (Art. 180(1)(a)) requires institutions to apply long-run averages of the one-year default rates when estimating the default probabilities. It is unclear what approach is to be adopted if a methodologically justified extrapolation of default rates for a complete economic cycle shows that the long-run default rate is clearly below the measured value. In that case, parameterization on the basis of the measured value would lead to a foreseeable distortion.

The RTS draft gives no specific guidance on how to define a "complete economic cycle". The economic cycle should reflect the forthcoming comments on Art. 181(3)(a) CRR.

Q4: Do you agree with the required number of default weighted average LGD calculation method introduced in Article 51(1)(b) and supportive arguments? How will this requirement influence your current LGD calculation method? More generally, what are your views as to balance of arguments for identifying the most appropriate method?

We are of the opinion that introducing the volume-weighted average loss rate for defaults as an alternative to the proposed approach, the number-weighted average, is a good idea. With this addition, the regulator gives institutions the, in our opinion, necessary possibility to use whichever approach better reflects their specific business cases or modelling methods.

Art. 51(1)(b) of the RTS draft says that the LGD should be calculated using the number-weighted average. For both the number-weighted and the volume-weighted calculation of the LGD, sound arguments can be found for or against each of the two variants. This is also apparent in the introductory text to question 4 and in the surveying of the national supervisory bodies as shown in the appendix. In our opinion, not only the presented method (number-weighted average LGD) but both variants should therefore be allowed. With all due respect for standardisation, we believe that the reasonableness of the estimation procedures should prevail over the wish for a standardised methodology. The decision must of course be taken plausibly on the basis of data and a consistent consideration of all the defaults in the PD

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and LGD estimation and the EL estimation be ensured. Below, we show why we regard the volume-weighted average LGD calculation to be a reasonable method.

An argument given for the number-weighted LGD is the consistency with the PD calculation, as this is also number weighted. Against this argument is that whilst the LGD and the PD calculation might well be consistent, there would nevertheless be variances within the LGD estimation, as the LGD estimation at the portfolio level would still be calculated on a volume-weighted basis. These variances would also be reflected in the EL estimation: in our opinion the LGD need not necessarily be estimated on a number-weighted basis like the PD, as it is part of the "Expected Loss" (EL) estimate, which in turn produces a euro amount – i.e. a "volume".

We raise as a further argument that unlike the number-weighted LGD estimation the volume-weighted LGD estimation is unbiased where there are correlations between the loss rate and the volume. On the basis of a very large data pool we found a significant dependence of the realised LGD rates on the volume. That volume-weighted rates are unbiased under such circumstances is shown by the following simplified numerical example. Simplifying assumptions have been made for this example of a model portfolio with synthetically generated data concerning the distribution of the volumes and loss rates and their correlation so as to make the simulation easier to run and also plausible for third parties. The core statements derived from the model calculation can also be confirmed on the basis of a large data pool, however.

Model portfolio:

- 1 million entries (synthetic data, not genuine data)
- correlated bivariate normal distribution for volume and rate
- average loss rate: 30%
- average volume: EUR 40,000

Correlation	-0.9	-0.5	0	0.5	0.9
Number-weighted estimate	30.0%	30.0%	30.0%	30.0%	30.0%
Volume-weighted estimate	27.7%	28.8%	30.0%	31.2%	32.2%
Rate measured on the same data basis	27.7%	28.8%	30.0%	31.2%	32.2%
PD of the random sample	1%	1%	1%	1%	1%
Expected loss number-weighted	120 EUR	120 EUR	120 EUR	120 EUR	120 EUR
Expected loss volume-weighted	110.80 EUR	115.20 EUR	120 EUR	124.80 EUR	128.80 EUR
Loss measured on the same data basis	110.80 EUR	115.20 EUR	120 EUR	124.80 EUR	128.80 EUR

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Consideration of the volume in the segmenting of the rates improves the number-weighted estimate as the continued example shows, but does not affect the fundamental problem of the number-weighted estimate distortion:

- The model portfolio (synthetic data, not genuine data) was divided into two segments (A: volume $\geq 40,000$ and B: volume $< 40,000$)
- Assumed correlation = 0.9

	Total	Segment A	Segment B
Number-weighted estimate	30.0%	22.8%	37.2%
Volume-weighted estimate	32.2%	23.8%	37.9%
Rate measured on the same data basis	32.2%	23.8%	37.9%

In so far as there is no correlation, both estimators produce the same unbiased result. If there is a correlation, then the volume-weighted estimate remains unbiased, whereas the number-weighted estimate does not. Segmenting the rates reduces the distortion of the number-weighted estimator but at the price of having to form more segments and thus reducing the quantities per segment, and hence increasing the statistic uncertainty. Volume weighting thus has the advantage that fewer segments are needed to map the relationship between volume and rate and thus other/further relevant risk drivers can be taken into consideration.

To avoid individual very large-volume cases from distorting the estimate, it must be ensured that there is representativeness for the actual business. If such cases also arise in the real-life portfolio, then they must also be included in the estimate. This can be ensuring by segmenting such cases (e.g. segment $> \text{EUR } 500,000$).

Individual case rates with a very high numerical value can arise in the calculation of the LGD or recovery rates (collection or recourse rates) as LGD components and likewise in the calculation of the CCF (conversion factor), if the base of the rate, i.e. the denominator, is very small.

Example for CCF:

Line one year before default: 1000

Balance one year before default: 990

Open line one year before default: 10

Balance on default: 1190

Additional recourse as of default: 200

$$\text{CCF} = (\text{Additional recourse as of default}) / (\text{Open line one year before default})$$

$$= 200/10 = 2000\%$$

In a number-weighted estimate all the individual case rates are included with the same weight. Cases with a very high individual case rate due to a very small base can thus massively distort the estimate. This can be countered by steps such as capping the individual case rates or excluding outliers. But this tends to produce a biased estimate.

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The volume-weighted estimate automatically solves this problem, as cases with a very high individual case rate due to a very small base are assigned a very small weight and thus do not distort the estimate even though they are fully included.

All in all, we would like to point out that switching to number weighting for LGD estimation would have a considerable impact on the approved procedures. Accordingly, the volume-weighted estimate should also be allowed at least as an alternative.

Q5: Are the provisions introduced in Article 52 on the treatment of multiple defaults sufficiently clear? Are there aspects which need to be elaborated further?

The approach presented in the RTS draft is in our opinion plausible. Due to the consistency of the LGD and PD estimation raised in Art. 52 of the RTS draft, we assume that, concerning the cure period, the effective date reference possible for the PD estimation is also possible for the LGD estimation. More clarity is required on the definition of 'limited timeframe'. Using examples is not sufficient.

Q6: Are the provisions introduced in Article 60 on the treatment of eligible guarantors for the purposes of own-LGD estimates sufficiently clear? Are there aspects which need to be elaborated further?

Art. 60 – Eligibility of guarantors and guarantees

If the risk-reducing effects of guarantees are taken into consideration under the advanced IRBA when estimating the PD or the LGD, then the guarantor must also be rated internally ((e)(i)). If the guarantors are treated by the institution using the standard approach, then those guarantees can be recognised under the standard approach, where the guarantor is an institution, a central government a central bank or an externally rated company ((e)(ii)).

Thus it remains unclear whether guarantees may still be recognised in the standard approach, if the institutions apply the foundation IRBA approach. On equal treatment grounds, these guarantors should also be recognisable in this approach.

From our perspective, it would be very helpful for institutions, if the supervisory bodies could provide them with indicative guidelines for the criteria mentioned in lit. a, c and d, so that institutions have a degree of orientation. The guidelines should not be obligatory for all institutions alike, however, but should be heeded accordingly in the light of the proportionality principle, size, risk profile and complexity of the business model. In addition, individual arrangements with the supervisory bodies to find an institution-specific solution should still be possible.

In addition, we urge that the contradiction between Art. 183(4) CRR and Art. 201(2) CRR explained in the text for consultation purposes be rectified to pave the way for implementation by institutions. The assumption on p. 88/89 only goes some way to solving this problem, in our opinion.

Q7: Do you support the view that costs for institutions arising from the implementation of these draft RTS are expected to be negligible or small? If not, could you please indicate the main source of costs?

The prohibition in Art. 4(3) of cooperation between model developers and model validators under outsourcing arrangements renders pool solutions common in Germany practically infeasible, especially as it is not clear how an institution can satisfy the requirement of CRR Art. 190(2)(f) CRR, if it has outsourced the development of the rating system as a key task of the credit risk control unit and Art. 4(3)

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RTS draft does not permit the outsourcing unit to be involved in the validation unit's activities. The provisions in CRR Art. 179(2) and Art. 190(3)(a)-(e) are de facto rendered null and void by the RTS draft provisions and the large number of advantages for institutions and supervisory bodies alike can no longer be used, see the opening comments and our response to Q2.

Having to forego pool-rating procedures would have a huge impact on the institutions affected: massive adjustments to the IRBA systems and for each individual institution's organisational structures would be necessary (especially installing resources for permanent local model development and validation). It remains unclear whether the validity of an individual institution's models can be shown in the long run without recourse to the shared data pool (as the starting point of shared modelling).

The independence demanded for large banks up to the senior management level is in principle not workable. It would necessarily entail, however, not only a massive adjustment of the organisation structures but also a duplication of activities, without an iota of additional objectivity. Here, we believe there should be no overshooting of the goal, particularly as the conflicts of interest in conjunction with model development and its validation are clearly smaller than, for example, for the organisational separation between front and back offices.

In any case, such a rigid organisational separation between validation and model development would clearly delay the model optimisation implementation processes.

Art. 4(2)(a) does not allow institutions to outsource areas other than those explicitly permitted under relevant legislation. This would render many existing and certainly meaningful outsourcing relationships impossible, such as for example outsourcing IT implementation, operating rating systems in a central computer centre or entrusting auditing to an external auditor.

Further considerable implementation costs would arise from switching to number weighting (Art. 51) for LGD estimation, if the requirements are not kept flexible. Here too, high costs for the IT and adjustment of the data links are likely. In that case, a new acceptance of the IRBA procedures would also be necessary.

Another cost driver in our opinion is the LGD for defaulted exposures. As already explained in the appendix of the RTS draft, the new information which has to be held ready causes a considerable implementation cost.

A key aspect of the cost drivers can only be estimated once it is clear how the numerous provisions in the RTS draft will be interpreted by the national supervisory bodies. The fleshing out of those interpretations will play a key role in the expenses and costs incurred by institutions for implementing the RTS draft.

By way of example, the three-year experience test places greater and measurable demands on the use of "broadly in line" rating systems, such as comprehensive internal use and also monitoring, validation and review by the internal auditing department. The institutions' use tests will also have to be adjusted due to the detailed requirements on using internal IRBA parameters in internal control. These adjustments will not only cause costs, but will also be time and above all staff and IT resource consuming.

In addition, sufficiently high conservatism adjustments depending on known insufficiencies and uncertainties in models, data and processes will be necessary. These required conservatism adjustments will cause HR and financial costs for institutions on the one hand, but will not, however, compensate for

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any lack of conformity at all in models on the other hand, leading to the question as to whether these conservatism adjustments make any sense at all.

There will also be expenses concerning pillar I stress tests and PD validation. For example, the methodology of the pillar I stress tests will have to be harmonised with that of the ICAAP stress tests. Furthermore, an appropriateness examination of the long-term PD averages (or indirectly via their fluctuations across the cycle) on the basis of stressed PDs and rating migrations will be necessary, which likewise entails a corresponding financial and HR expense.

These implementation costs are admittedly spread over individual units and functions in institutions; in their totality they will, we are convinced, generate a considerable additional expense for institutions, so that we consider the regulatory benefits and the quality improvements as much lower than the associated costs for the institutions.

Q8: What are the main benefits for institutions that you expect by the adoption of these draft RTS?

In the sense of enhanced harmonisation we see potential for possible advantages and disadvantages for institutions in various member states being equalised, which would improve not only transparency but also competitive conditions among EU institutions. Through implementing this RTS draft and the points we feel to be in need of improvement, institutions would in general gain clarity over the approach of the competent supervisory bodies in how they review and approve the IRB approach.

In principle, we also support your proposal concerning an independent validation function and the resulting increase in objectivity. The actual detailed regulations in the RTS draft largely focus, however, on formal and organisational issues. The scope and degree of detail in the proposed provisions overshoot the goal, in our opinion, and are not suitable especially in the context of pool projects for decisively improving the objectivity of validation. The mechanisms which already ensure a high degree of independence in pool projects have been presented above. In principle, we believe the conflicts of interest in conjunction with model development and its validation are clearly smaller than, for example, for the organisational separation between front and back offices. Possible conflicts of interest are being minimized by the fact that institutions have long since established validation concepts and internal control systems which are reviewed by internal auditing for compliance and which are also subject to regular audits by national supervisory bodies.

As indicated by our responses to your questions, we still see a need for further clarification and changes. Depending on how our suggestions are incorporated into the final version of the RTS, we consider the measures on the whole to be a positive improvement for institutions, in so far as they reduce the outcome variability. Against the background of the cost-benefit aspects, minimum organisation standards must, however, be kept out of the RTS as far as possible. Especially concerning the widespread pool models in Germany the wording in Art. 4(3) RTS draft needs significant improvement so that the advantages gained from the RTS draft are not lost elsewhere. This loss of pool models would under no circumstances result in more but rather less objectivity.

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Q9: Do you expect that these draft RTS will trigger material changes to the rating system (subject of the RTS on the materiality of model changes)? If yes, could you please indicate the main sources of the changes (please list the relevant articles of this draft RTS)?

Art. 4(2)

Art. 4(2)(a) does not allow institutions to outsource areas other than those explicitly permitted under relevant legislation. This would render many existing and certainly meaningful outsourcing relationships impossible, such as for example outsourcing IT implementation, operating rating systems in a central computer centre or entrusting auditing to an external auditor.

Art. 4(3)

The prohibition in Art. 4(3) of cooperation between model developers and model validators under outsourcing arrangements renders pool solutions common in Germany practically infeasible, especially as it is not clear how an institution can satisfy the requirement of CRR Art. 190(2)(f) CRR, if it has outsourced the development of the rating system as a key task of the credit risk control unit and Art. 4(3) RTS draft does not permit the outsourcing unit to be involved in the validation unit's activities. The provisions in CRR Art. 179(2) and Art. 190(3)(a)-(e) are de facto rendered null and void by the RTS draft provisions and the large number of advantages for institutions and supervisory bodies alike can no longer be used, see the opening comments and our response to Q2.

Having to forego pool-rating procedures would have immense effects on the affected institutions: massive adjustments to the IRB systems and for each individual institution's organisational structures would be necessary (especially installing resources for permanent local model development and validation). It remains unclear whether the validity of an individual institution's models can be shown in the long run without recourse to the shared data pool (as the starting point of shared modelling).

Each of these changes can and will, given an unchanged final version of the RTS draft, lead not only to major changes to the prevailing IRB rating systems, but at least in part also to major shifts in the institutions' model landscape.

Art. 12 – Adequacy of the validation function methods and procedures

Under Art. 12(e) validation methods are to contain both back testing and also benchmarking approaches. We support this in general. However, it should be noted that there not always appropriate benchmarks for all IRB portfolios. The standard credit risk approach is not a reasonable benchmark for internal rating procedures in either its current or future form (on the basis merely two risk factors). Here, other internal rating procedures, which are not readily available every, could at best be applied. We therefore suggest that the requirement be restricted by adding "in so far as meaningfully possible".

Art. 24 – Assignment to a rating level

Under Art. 24(1)(c) RTS draft it must be ensured that a uniform rating grade is assigned within the same institution group for every obligor in the exposure categories companies, institutions, central governments and central banks and for equity exposures where an institution uses the PD/LGD approach. In our opinion, this requirement does not arise from Art. 172(1)(e) CRR. The requirement there relates, as we understand it, only to individual institutions and not to institution groups. Were the application of a group-wide rating to be made obligatory, this would raise the question as to how group institutions which

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handle the obligor in question under the standard approach should act. Furthermore, there would also be liability issues, if for example a subsidiary with a differing rating estimate has to apply the parent company's rating and the obligor then defaults. It is also unclear which rating should be used for pricing. In Germany, there is currently a regulatory requirement that a subsidiary institution may not simply accept the parent company's rating but must have the ability to adjust it if necessary. Would this requirement no longer apply in future? Furthermore, it would also be doubtful whether the entire outsourcing requirements pursuant to Art. 4 RTS draft would come into play where group-wide rating is used. Therefore, this requirement should be obligatory only at the individual institution level.

Art. 27 – Triggers of default of an obligor

Here, consistency with the RTS on materiality thresholds for determining payment default for the IRBA default definition must be ensured.

Art. 28 – Definition of default

Art. 28(1)(d): The consultation text implies that as soon as an institution chooses the identification of default at the obligor level, this has to be ensured consistently across the whole banking group regardless of obligor type. There are good reasons for some banks to apply a default definition (and rating) at obligor level also for retail rating systems, where the above requirements cannot be fulfilled without undue effort. We would therefore welcome a limitation of this paragraph to non-retail exposures as is provided for by article 172 and 178 of the CRR.

Art. 28(3)(b): This paragraph imposes limitations on how banks assess their retail portfolios and could lead to changes in bank infrastructures. We would like this paragraph to allow for either obligor or facility level default identification for different locations, legal entities or other appropriate segments as long as the respective policy is sufficiently clear to assure unambiguous and consistent identification of defaults over time.

Art. 29 – Return to non-defaulted status

Studies by the European Banking Association on residential property show that there are currently considerable differences in Europe in both cure periods and rating assignment after return to a non-defaulted status. Here, harmonisation is desirable in order to address this cause of outcome variability.

Art. 73 – Calculation of own funds requirements

The valuation allowance comparison should be carried out separately for the portfolios of defaulted and not defaulted exposures. It should not be allowed to offset losses on valuation allowances for defaulted exposures against gains on valuation allowances from not defaulted exposures. (Art. 73(h)(i) RTS draft). This calculation method reflects the current CRR approach. There should be no further breakdown of the valuation allowance comparison (for each exposure, for homogeneous portfolio, see pp. 119ff. of the RTS draft) above and beyond the CRR.