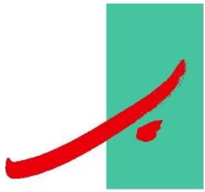

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FBF RESPONSE TO EBA DISCUSSION PAPER ON FUTURE OF THE IRB APPROACH (EBA/DP/2015/01)

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

I. General comments

The FBF welcomes the proposals outlined by the EBA in its Discussion Paper on the future of the IRB approach. We are committed to contributing to a constructive debate on the role of IRB models and consider this consultation as an opportunity for the industry we represent to make its case.

We understand the EBA supports internal models and believes that, provided planned regulatory developments on outstanding issues in this space such as model comparability, robustness and transparency can be addressed, internal models will remain a cornerstone of the CRD and of banks' risk management. We share these views.

We also understand the discussion paper opens many questions some of which may be addressed down the line, most likely around 2018 and as part of work underway at the Basel Committee level, potentially leading to legislative changes by the European Commission. Given the burden that regulatory developments planned by the EBA may entail and given the ECB internal model assessment underway within euro area banks, we hope these efforts will not be lost on our members and that they will lead to a convergence of stakeholders views about the extent of changes to bring about.

We welcome the EBA's effort to lay out a plan organising issues by groupings, with relevant timing and milestones. We believe it is of paramount importance that the EBA strives to coordinate with the Basel Committee work in order to support its plan. Disclosures around how this institutional governance may work in practice would be welcome.

We believe nonetheless that 2018 is too close of a deadline in order to complete the full scope of regulatory initiatives to be undertaken including validation by supervisors.

We would therefore like to propose that the 2018 milestone is not inclusive of the time required for the assessment and approval of changes by the competent authority. We believe adequate time should be granted to banks in order to properly take on board EBA proposed regulatory changes; a grandfathering period could support this goal. The EBA should keep in mind time needed by supervisory authorities to validate changes in models and / or model parameters and ensure this is adequately reflected in its proposed plan.

In order to satisfy itself that proposed regulatory changes are leading calculations underlying models and parameters to converge hence to more comparability, the EBA could monitor the impact of those changes through its annual supervisory benchmarking exercises and the progress achieved by banks towards convergence.

Please find below our answers to the discussion paper's questions.

II. Answers to questions

1. 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?

The proposed grouping and its ranking seem appropriate.

From our point of view, it is crucial to give banks a full vision on how the revision of the standardised and IRB approaches by the Basel Committee will be taken into account as part of the EBA proposed phasing. It is not sufficiently obvious in this context how the EBA intends to cover in particular points such as harmonisation across jurisdictions. More generally, coordination and regulatory policy convergence between the EBA and the Committee are paramount. We understand from the BCBS's "Reducing excessive variability in banks regulatory capital ratios –a report to the G20" published in November 2014 that the review of credit risk internal models will be consulted on by mid-2015. We believe it is essential that the EBA reflects the Committee's review into the RTSs and guidelines to be published by year-end and clearly indicates where the regulatory stance is already set and where opportunities for discussion exist.

While risk parameters that will be used for Expected Loss impairment are different from those that are used for regulatory capital, it seems important during the EBA's IRB review to maintain consistency between the accounting and prudential frameworks on key elements (default definition, discounting rate, ...).

As already stated in the introduction, EBA's proposed timing seems ambitious. In order to engage the industry in the proposed plan and to achieve results on the convergence goal within the time constraint, the new regulatory requirements could be applied first to a set scope of portfolios only, in the event a grandfathering clause may be acceptable for other portfolios.

We strongly believe that the EBA's regulatory stance should take into account the fundamental differences between the retail and the wholesale portfolios.

In addition and considering that this thematic approach will affect all internal models, the EBA could seek a delivery simplification by sequencing the validation of proposed groupings, for example by completing the review of the definition of default before launching the LGD and conversion factor estimation, and not having this two topics overlap. Please refer to question 3 for further details on timing.

As a secondary remark, we notice that most RTS related to credit risk parameters are covered by the proposed plan except the RTS on article 164 CRR (which specifies the conditions that competent authorities shall take into account when determining higher minimum LGD values).

2. What would you consider the areas of priorities?

The priority order proposed by the EBA seems relevant.

First priority referring to default is the starting point for modelling PDs and LGDs and therefore enhances harmonisation. The RTS related to CRM being in phase 4 makes sense to us as these relate to minor areas and not to the whole CRM framework.

3. 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?

According to the proposed time frame, institutions have to implement all the new planned adaptations proposed by the EBA by the end of 2018 which does not represent a sequential approach for banks. As stated in the introduction, we anticipate that this timing will be too tight given that supervisory approval processes appears to be included in the 2018 deadline according to the discussion paper.

We strongly wish that the proposed timeframe be extended beyond 2018 for the implementation at banks level:

- Before implementation of new thresholds into models, banks need to collect 5 years of historical data according to set levels. In practice, it is not considered as a feasible/reasonable scenario to recalibrate all current historical data taking into account new thresholds.
- EBA's RTS CP 36 proposed a transition period of maximum 2 years for banks in order to modify their models. A change of default definition that impacts the number of defaults has material operational implications and may be simply impossible to apply retroactively –an historical

data set ranging from 5 to 7 years may not be adequately corrected, integrated and tested within the risk management system over a 2 year period only.

- Reviewing models with a one size fits all approach may not work in practice: for instance, the French national competent authority bare minimum timeframe to review models was around 18/24 months, which covered on-site visit, draft report and recommendations validation. You will find in the appendix, an indicative example of the overall timeframe needed in France to review a model from beginning to end of the process. It would be useful to know which national practices the ECB will be building its approach on going forward.
- Moreover, it is important to bear in mind that 75% (ITS, RTS and GL) of regulatory developments planned by the EBA are still undefined. As stated by the EBA at §103 of the discussion paper, "It is impossible at this stage to estimate the global impact of the changes that may be proposed on the capital requirements and capital adequacy ratios of the institutions".

As part of the planning proposed by the EBA, it is crucial that the timing of the approval process is also tightly monitored by the supervisors and that they do everything possible to reach a decision within a reasonable timeframe (6 months as mentioned in article 20 of CRR for joint decisions would be a good start).

A predefined approval calendar could be set up with the supervisors – together with a roll-out plan – to enable banks to anticipate and organise changes: it could be a sequenced workload on the basis of exposures volumes, where banks would implement proposed regulatory changes on the most significant portfolios first and by discussing with their supervisors:

- A priority area covering the major models/exposures of a banking group, based on its model cartography;
- Implementation of the changes by portfolio, including all parameters;
- A sequential implementation of the changes across the bank.

Another option could be to sequence the timing of the proposed groupings, for example by completing the review of the definition of default before launching the LGD and conversion factor estimation, and not having this two topics overlap

As stated in the Discussion Paper, this could address the principles of proportionality mentioned in § 39.

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

We think most of the aspects related to the definition of default are addressed either in the RTS or guidelines. We understand that the following aspects will be treated:

- Days past due : start day and counting of days past due
- Materiality threshold (see our response to EBA/CP/2014/32)
- Number of default through the multiple default concept
- Return to non-default status criteria
- Forbearance: harmonisation of definition to increase consistency with the ITS on supervisory reporting
    - Unlikeliness to pay

- Restructured credit
- Contagion
- Probation period

- Convention for incoming payments with regard to past due
- Past due not linked to debtor's financial difficulties

We would also like to emphasise the need to take into account expert judgment as far as defaults are concerned, and especially for non-retail counterparties.

5. 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?

So far only few banks have experience with adjustments of historical data.

The adjustment of historical data is a difficult exercise both on a methodological and implementation point of views. While it may be feasible to complete descriptive data based on historical snapshots, it is impossible to build a collection of events where they have not been registered at the time of occurrence. This is the challenge banks would have to face with a new definition of default. It is impossible to retrieve historical qualitative default criteria, for example those that relates to "unlikeliness to pay".

We are also concerned that uncertainty around models could increase due to adjustments, such as proxies, banks will have to introduce in their models. This is a last resort approach banks carry out only when there is no other solution to satisfy regulatory requirements. Moreover we underline that external data may not be available for Retail portfolio and other specific portfolio.

In this area the objective of comparability and simplicity should remain a priority. Consequently, there is a need to find a balance between these objectives and the requirement of sound historical data as per the CRR and the discussion paper.

6. 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?

Most of the time, it seems to be unfeasible to rebuild historical data in order to take thresholds into account retroactively. Where feasible, this entails heavy workload: data collection, change management, changes in parameters and rating systems as well as IT development. This remark concerns every kind of changes that relates to default or dealing with historical data that are used for modelling purposes.

One option would be to allow banks a grandfathering clause once the EBA's RTS's are published. Banks would be able to use this grandfathering clause only in the event calibration, for instance, requires further adjustments.

7. 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?

We face difficulties in estimating whether the expected new regulatory requirements will lead to material changes or not because most of them are yet to be detailed and consulted on. Some of the proposed changes might entail an entire review of existing models.

Hence we believe the EBA should find a good trade-off between the need for harmonisation and comparison of models and maintaining already approved models. We think that it is crucial in this context that the EBA and the Basel Committee initiatives are well coordinated in order to avoid multiplicity of changes and to optimise banks workload and costs. This will help to enhance the sound harmonisation EBA is expecting from banks.

Under an agreed plan with the supervisor, one way to deal with all the proposed changes and their regulatory approval process could be to consider as material only those for which impacts on RWAs are above a specific significant thresholds suitable to this exceptional transition period, notwithstanding the Commission's Delegated Regulation (EU) n°529/2014 on the materiality of extensions and changes.

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

The industry welcomes this initiative. The work done via the IIF is in the same spirit and addresses most areas mentioned in this discussion paper.

Identified weaknesses and divergences should be reduced thanks to the provisions that will limit the technical differences in the quantification of risk parameters, such as the estimation of the default rate clearly explaining how to estimate the numerator and the denominator or the use of the same type of weights to estimate LGD.

Nevertheless, harmonisation should not be an impediment to the maintenance of risk sensitive models that reflect internal processes and policies, as well as management practices.

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

We believe the IIF report (*IIF Risk-Weighted Assets Task Force Final Report November 2014*) covers a number of topics related to the estimation of risk parameters harmonisation and we recommend the EBA to refer to this report in order to address this question.

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

The ability of banking groups to fulfil this requirement will depend on the entity and / or the portfolio concerned.

Remark: it seems there is a typo error: 4.3.3 rather than 4.3.4?

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

We face difficulties in answering this question as most changes that relate to this topic are not addressed so far. However we think the direction of the proposed changes is adequate and should tend to reduce discrepancies.

12. What else should be covered by the GL on the treatment of defaulted assets?

We would like to underline that the treatment of defaulted assets has a minor impact on RWA even if it may in part explain discrepancies in global capital requirements. Indeed the treatment of defaulted assets includes the recognition and measurement of expected credit losses that will be used for the calculation of the total solvency ratio. It would be very useful to address this topic in particular as part of benchmarking and disclosures exercises.

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

Roll out plan –We recall that it is necessary to maintain some flexibility in the 5 year deadline for the implementation period of the IRB approach. In particular, it is essential that competent authorities ease rules so that different situations such as mergers and acquisitions can be taken into account. Indeed economic conditions, business models adaptation and the structure of portfolios may change over time leading institutions to review their plan.

Preliminary assessment contacts and discussion have to be set up with regulators in order to assess the impacts when specifying the conditions for PPU and roll-out.

14. 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?

We think most institutions organisational structure or allocation of responsibilities may be impacted due to the proposed adaptations.

This involves, among others, internal risk management and corporate governance (organisation and level of independence of the validation function and internal audit; and the general involvement of the board: please refer to the FBF's response to consultation paper EBA/CP/2014/36 on assessment methodology, question 2), stress tests processes. In particular:

- Stress test. We wonder if the EBA request to generalise the stress test / scenario approach rationale in order to qualify the forward-looking aspect of PD and LGD calibration is strictly aligned to article 177 of CRR. Generally speaking, stress test is a tool dedicated to assess capital adequacy for Pillar 2 discussions. This rationale would lead to setting up systematic stress tests on an annual basis over the full IRBA scope. PD and LGD parameters should be calibrated on historical long run average.

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

We agree that CRM is a low priority because EBA's objective is to focus on specific points (conditional guarantee, liquid assets, master netting agreements).

16. Are there any other significant intra-EU or global discrepancies?

We identify other significant discrepancies as sources of RWA variance mainly in the supervisory area. For example:

- supervisory decisions: floors, add-ons;
- supervisory practices: double validation of models by home/host authorities where local approaches apply.

17. 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 think that disclosure is a fundamental topic and clearly understand the need of investors, analysts as well as external auditors and rating agencies to be able to understand institutions financial performance. We also agree that adequate disclosure will enhance transparency and reinforce internal models credibility.

However we want to outline that disclosure has been largely increased quantitatively and improved qualitatively in the last few years with the development of Pillar 3, the EDTF process, the various stress-tests' disclosure (EBA-ECB, DFAST and CCAR) and the EBA Transparency Exercise.

Therefore we think that, even if some improvements is always welcome, a strengthening of disclosure is not a priority today and a trade-off should be found between:

- external stakeholders need and the type of information to be disclosed so that institutions can keep their specificities as well as their competitive advantage;

- relevance of information disclosed in various exercises and an overflow of data that could be misleading for users (which are puzzled by the lack of consistency between different requirements).

We do not agree with the unwarranted statement that market participants are largely concerned about the opacity of IRB model:

- This has been the case in 2008-2009 for some specific assets (mostly securitisations or structured transactions) but we think that the already improved disclosure and the adequate actions of regulators and supervisors (supervisory review, comprehensive assessments, stress tests) have since largely reduced these concerns and increased the confidence in the banking sector soundness. For instance, the joint action of the EBA and the ECB to set up respectively the Single Rulebook and the Single Supervisory Mechanism in 2014 have been real milestones.
- Paradoxically, we think that the main concern of market participants today is more the uncertainty created by the low coordination and length of numerous regulatory bodies' initiatives on this issue than their doubts on the quality of banks' assets or their trust in RWA.

We believe that a large (silent) majority of market participants is rather asking for clear signals of confidence from the regulators and supervisors once IRB models will be assessed.

We strongly disagree with the publication of benchmarking exercise results whether through public disclosure or on the EBA website for the following reasons:

- The requirements defined in the final version of the BCBS disclosures (Basel Committee on Banking Supervision Standards Revised Pillar 3 disclosure requirements, January 2015) already includes numerous templates that provide a wide range of meaningful information to external stakeholders.
- These exercises rely on hypothetical portfolios that have nothing to do with banks' real business.
- They mainly help (aim) competent authorities or the EBA at understanding models and comparing them for regulatory purposes ;
- Publishing such information will increase complexity of the disclosed information and may confuse external stakeholders, thereby leading to misleading interpretation and analysis.
- It may be difficult to establish a link with Pillar 3 disclosure. This may raise more questions rather than improve understanding of institutions performance

We would like to take this opportunity to emphasise that we strongly disagree with the Basel Committee's proposal requiring banks that are using the IRB Approach to disclose hypothetical capital requirement according to the Standardised Approach for credit risk. This approach is too simplistic and will again create confusion amongst external stakeholders, leading to irrelevant questioning and complex debates which would be difficult to solve without the disclosure of proprietary or confidential information.

18. 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?

The Transparency Exercises have indeed provided harmonized, easy to access information on RWA to users and seems to have been appreciated. According to the feedback received by banks, their effective use by analysts and investors has been however rather limited.

We have the following concerns as far as the additional ad hoc disclosure are concerned:

- We question the appropriateness of ad hoc disclosures on the EBA website. As mentioned above, we think that these requirements will just increase the volume of disclosed information and may introduce confusion amongst stakeholders. Moreover, we wonder whether the EBA may not be going beyond its mandate by so doing.
- We think that for this ad hoc disclosure to be relevant, it has to be consistent with Basel Committee's requirements. There must be an easy-to-establish link between disclosed data (i.e. stakeholders shall be able to switch from one set of information to the other one without having to reconcile the information).
- There is no information on the frequency but we suggest this should the frequency defined by the Basel Committee.

- Additional disclosed data should ultimately add value to existing regulatory disclosures. Such high granularity is often useless to most market users, but it provides valuable information on market shares and customers to competitors (notably to non-EU banks).

We do however support the EBA's proposal to issue guidelines for reporting ad hoc information to be harmonised and therefore avoiding any discrepancies.

Institutions shall publish information consistent with the Basel Committee disclosure requirements as at January 2015 from end 2016. This ad hoc disclosure should not be made mandatory before the enforcement of the Committee's disclosure and the implementation of new regulatory requirements. One should not assume this represents a limited burden on institutions which have already to implement an unprecedented number of regulatory changes and of disclosure requirements in a very short timeframe. In addition, discrepancies may emerge while regulatory requirements affecting models are being reviewed –i.e. the regulation would not be stabilised as of yet.

We are also concerned that the EBA's approach to anticipate on Basel Committee disclosures may create an unlevelled playing field with non-EU banks.

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

There is today a growing trend towards standardisation as well as homogenisation on this topic. We agree on the need for harmonisation and comparability. However, too much harmonisation may lead to the opposite effect, could be detrimental to simplicity and lead to misleading comparison. To maintain this objective of comparability, institution's internal organisation as well as their economic model should also be taken into account. We strongly agree with the EBA proposals to be aligned with EDTF, IRTF and IIF ones.

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

As for LDP portfolios, we welcome the fact that EBA wants to deliver a definition and to reflect on what should be the best treatment of this type of portfolio for internal modelling. LDP portfolios may represent a substantial portfolios for some banks, relating to some counterparts with high volumes of exposures.

First of all, with regards to the definition of LDP, sovereign exposures should be considered aside due to the very specific nature of their default pattern. As for using the number of defaults identified within a certain period of time, we believe this is not the best solution as it may also depend on the number of sound counterparts (proportionality principle) and cannot be interpreted marginally. More generally, we would consider more appropriate a definition which provides greater latitude.

Also, we have to bear in mind that on LDP portfolios, on the basis of the national decision, A-IRB approval were deployed through large transversal projects in order to provide this specific perimeter

with internal models. In particular, national authorities pushed banks to work specifically on data management by developing data warehouses for LDP. Therefore, LDP perimeter has become more adequately tracked through the years thanks to more adequate databases. Moreover, internal models were mostly developed through a tight collaboration between quantitative and qualitative experts. This type of modelling is all the more resilient as every modelling choice is supported by qualitative expertise. Consequently, we believe that the statement by the EBA that LDPs are "less suitable for internal modelling than other portfolios" (paragraph 49) seems too hasty: the modelling approach is only different in order to capture the specificities of LDP.

In addition, A-IRB developments allowed banks to move towards better practises in terms of risk management, including LDPs. We would like to highlight the fact that capitalising on what has been developed so far is for the sake of better risk management. More specifically, we are in favour of maintaining some flexibility in the treatment of LDPs, and giving the opportunity to banks already in A-IRB to maintain a risk-sensitive approach across all portfolios through the use of internal models.

21. How would you ensure appropriate use of the IRB Approach in a harmonised manner without excessive concerns of the so called 'cherry picking'?

To avoid any cherry picking the IRB Approach should remain attractive for institutions. Moreover, we would like to suggest that PPU be maintained for less significant entities, in order not to apply unduly burdensome requirements and abide to the principle of proportionality.

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

We think that moving towards the harmonisation of the exposure classes between the IRB Approach and the standardised one is meaningful. This consistency is all the more important as the standardised approach will be used as a floor to the IRB approach and serve as a reference point.

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

We believe that the TTC approach as part of parameters calibration is relevant for risk management purposes. TTC indicators are key decision making tools that, when combined with PIT measures where necessary, are fundamental to a sound risk management framework.

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

We think that data waivers should not be removed from the CRR because this may create an incentive for banks to switch exposures to IRBA in specific and/or exceptional cases. This is particularly true in

case of portfolio acquisitions where there can be limited access to historical data observations. In such situations, removing this possibility would be unduly detrimental to banks.

25. 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?

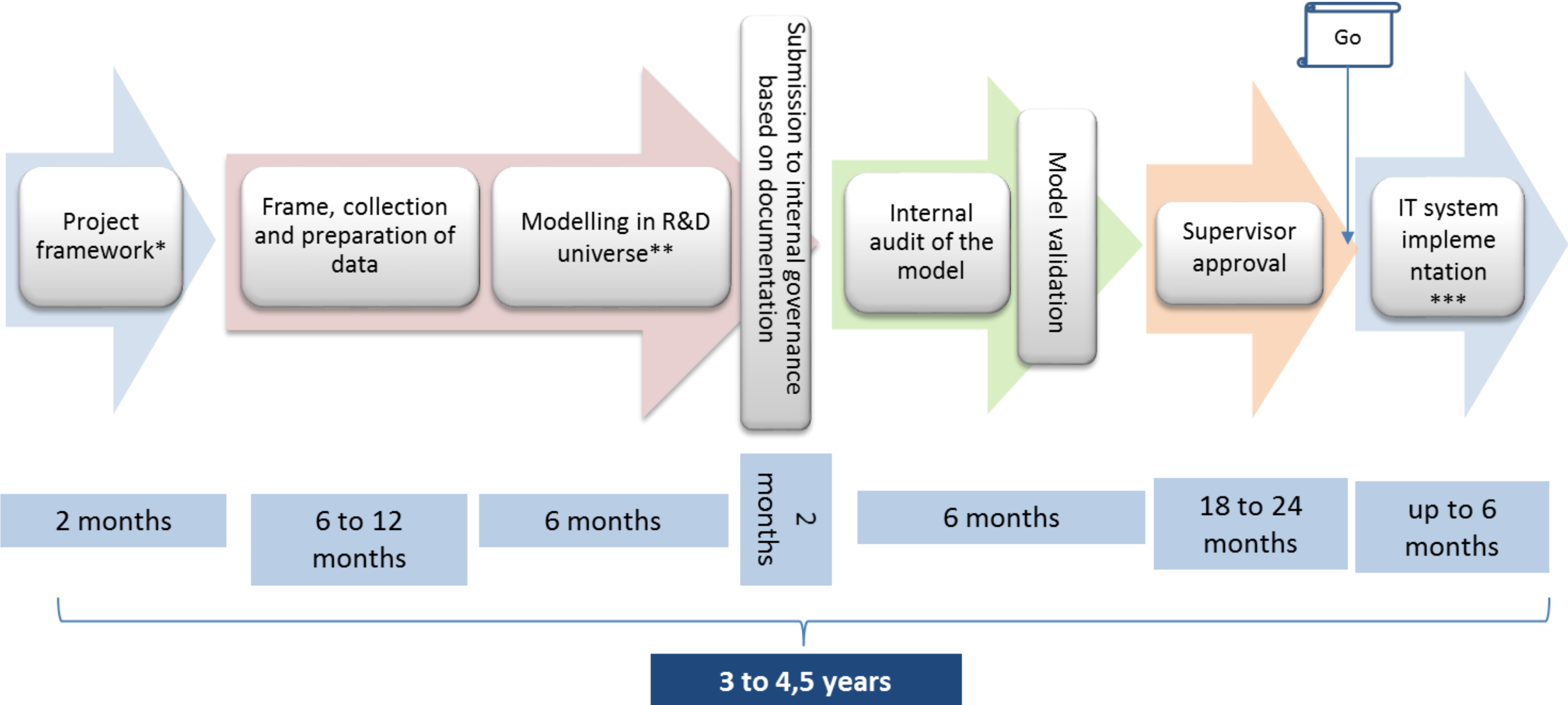
The discussion paper proposes in §186 to remove the "double default" methodology taking into account its complexity and its scarce application. We are strongly in favour of keeping the option to apply this methodology in the future framework for banks which "double default" is relevant to.

As a matter of fact, the "double default" methodology aims at capturing the lower risk of an underlying exposure hedged by a protection provider, based on the simple assessment that the risk of both a borrower and a guarantor defaulting on the same obligation and at the same time may be substantially lower than the risk of only one of the parties defaulting.

To this extent, the Basel Committee developed in 2005 a sound approach in order to capture this lower risk without introducing any new risk parameters nor complexity through new internal models, but simply based on a cross-utilization of the borrower and the protection provider risk parameters (PD, LGD).

In our view, the "double-default" treatment addresses a real economic situation where the combined risk of loss for a lender is less than the risk of only one counterparties defaulting (the borrower or the protection provider). Furthermore, the treatment defined by the Committee does not introduce complexity and should be - in our view - maintained as an option in order to encourage financial institutions to hedge some of their exposures, even the one benefiting from a favourable internal treatment. To this extent, double-default is an interesting and useful tool for managing credit and concentration risks on both Pillar 1 and Pillar 2 frameworks.

Appendix: Indicative timeframe for fundamental model review and validation in France



Notes:

- Each module must be implemented sequentially with no overlap
- This timeframe is an estimation for one model, concomitant reviews of several models could take more time

* Interpretation of standards, normative aspects, definition of objectives, modelling strategy, stakeholders, planning

** Modelling (working group with experts), tests (on default, for example) and impact studies

*** Based on the nature of IT developments to be implemented