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Finance for Europe

Consultation response

EBA Consultation on Draft Guidelines on Credit Risk Mitigation for institutions applying the IRB Approach with own estimates of LGDs

10 May2019

About AFME:

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

General Comments:

AFME are pleased to have the opportunity to comment on the EBA's proposed GLs on Credit Risk Mitigation for institutions applying the IRB Approach with own estimates of LGDs. We welcome the EBA's work on the clarification regarding the eligibility requirements for different CRM techniques, namely funded and unfunded credit protection (e.g. collateral and guarantees) which are available to institutions, and how institutions may recognise the effects of different CRM techniques for capital requirement purposes.

Nonetheless, the Guidelines, which are part of the EBA's overall IRB repair work programme, come at a time when industry is facing a number of regulatory implementation challenges, especially in light of the forthcoming Basel III framework. One of the main challenges will be achieving the required IRB changes (such as implementing these Guidelines) by the 2021 deadline, which will be further compounded by the changes to models which will come as a result of Basel III. Many EBA IRB repair model changes will be redundant once Basel 3 is binding. For example, the ability to model LGD and EAD is removed for certain portfolios, and, in relation to CRM, indirect exposures to guarantees not just insurance guarantees. As well as the preference to have certainty regarding the requirements over time, industry would welcome more harmonised implementation of changes within an acceptable and considered timeframe so these can be incorporated in model (re-) development in one go instead of incrementally. Ultimately the clarification of the CRM approaches which these draft Guidelines are aimed at providing should be considered jointly with the changes related to the finalization of Basel III to avoid excessive model volatility within a very short timeframe.

This request also reflects the fact that the current timeline for supervisors to approve models is long, often being drawn out over multiple years. In addition, ECB prioritisation of on-site inspections adds to the turnaround time for approving model changes. Generally, model approval changes take 12 months at best, more often than not 24 months +, especially where joint decisions are needed. Taking all of the points raised above into account, if there is to be an adjustment to the implementation deadline of 2021 to align with the Basel III implementation, the additional time available will need to be available to both banks and regulators. An adjustment for regulators alone will not give banks time needed to combine the Basel 3 reform and IRB repair changes to their models and make single applications per model to their regulators. Industry would welcome clarity on this from the EBA and Commission as soon as possible. This would be useful given the knock-on effect this may have on bank implementation programmes and planning, at a time where banks and clients are facing a number of uncertain headwinds.

In respect of the consultation itself there are a number of areas in particular we would like to highlight which are of concern to our members:

- We are strongly concerned by the requirement foreseen in paragraph 20 (d) (and the similar requirement in paragraph 21 (b) for collateral for leasing exposures) with respect to the eligibility of physical collateral which is movable and not in possession of the institution. In our opinion, requiring a legal opinion for movable collateral would be extremely burdensome and its application would penalize important sectors of the economy, such as shipping and aviation as well as the leasing business and trade and commodity financing, to the point of making them unviable to finance;
- Re-assessing the legal enforceability of a collateral arrangements in a given jurisdiction for each obligor as required by paragraph 19 of the guidelines also seems excessively burdensome and lacks justification in the absence of other changes in the collateral arrangement or applicable legal framework. Substantive variation to the terms of the contract may be better appreciated by exposure class or obligor type.
- The requirement to separate between guaranteed cash flows and other cash flows and the exact allocation of the guarantee cash flows to the same guarantee will be operationally challenging;
- Restrictions to the use of the substitution under the A-IRB approach to situations were recovery costs on the UFP are negligible (article 36 [b] of the guidelines) should be removed to avoid creating a distortion between F-IRB institutions that are not subject to this additional eligibility condition and A-IRB institution
- Clarification of what is required under article [39] to be considered as “able to recognize a funded credit protection in the estimation of the LGD of comparable exposures to the guarantor” is needed.
- The compulsory application of Part Three, Title II, Chapter IV requirements when the Guarantor falls under the Foundation approach for computing the “RW floor derived” from the articles 161 (3) et 164(2) of the CRR might disincentive modelling under the AIRB approach or discourage IRB-A institutions to take UCP from guarantors falling under the FIRB Approach. This is especially concerning given credit insurers will fall under the FIRB approach once Basel III reform will be finalized.

Question 1: *Do you agree with the proposed clarifications on eligibility requirements in accordance with Article 181(1)(f) of the CRR?*

With regard to the clarifications of eligibility requirements, AFME's members still consider there are some aspects which could be made clearer. For instance, it is not clear if the EBA considers there to be a difference between the requirement for an AIRB bank to be 'fully consistent' with the CRR requirements listed in paragraph 18 (of the draft GLs) and the requirement for an FIRB bank to 'comply' with the same paragraphs in order to recognise collateral. By way of background, paragraph 18 in the draft Guidelines provides a general mapping, by collateral type, to the legal certainty and valuation collateral eligibility requirements in Chapter 4, Section 3 of Title II of CRR with which AIRB banks are expected to be 'fully consistent' when estimating LGD. The term 'fully consistent' first appeared in the RTS on IRB Assessment methodology as an extension of the CRR requirement in article 181(1)(f) to be 'generally consistent with the 'collateral management, legal certainty and risk management' requirements in Chapter 4, Section 3 of Title II of CRR.

Secondly, we understand that "A-IRB institutions have the possibility to reflect in their estimates protection of lower quality" as long as "the collateral agreement is legally effective and enforceable," and "the rules governing the revaluation of the collateral, including methods and frequency" are met. This would appear more restrictive than the CRR. We underline that in A-IRB, as indicated in article 108(2) of CRR, CRM are taken into account according to Chapter3.

The Draft guidelines also maintain eligibility criteria that some collateral, in particular for general securities, which some banks might not be able to meet. In some cases, those collaterals might however have a material positive impact on the level of realised LGD. Additional clarification is requested on the appropriate approach to properly acknowledge such cash flows (see also answer to Q7).

In relation to the proposed FCP eligibility requirement for an institution to have "*the right to liquidate or repossess the collateral in a reasonable timeframe, also in the event of the default, bankruptcy or insolvency of the obligor and, where applicable, of the custodian holding the collateral*"[1], we note that the addition of the word "also" (which does not appear in the Art 194(4) CRR equivalent in Chapter 4[2], appears to clarify (helpfully) that there is no need for an institution to be able to retain assets in the event of a custodian insolvency or default (which would, of course, not make sense). The requirement is simply that the assets are bankruptcy remote to the custodian. It would be helpful if this could be explicitly confirmed for the purposes of both the AIRB and under Chapter 4.

In relation to the proposed eligibility requirements for UFCP (in relation to which no specific consultation question is posed): given the current requirement for Chapter 4 eligibility in connection with (amongst other things) UFCP recognition in a large exposures context[3] as well as in light of the future IRB output floor, institutions applying the AIRB may sometimes wish to structure their UFCP in line with the eligibility requirements of Chapter 4. It would be helpful if the EBA could confirm (akin to its comments in the consultation on the meaning, in relation to FCP, of Article 55 of the RTS on IRB assessment methodology for FCP[3]) that compliance with the Chapter 4 UFCP eligibility criteria constitutes

[1] Paragraph 15(1)(a) of the draft guidelines

[2] "Institutions may recognise funded credit protection in the calculation of the effect of credit risk mitigation only where the lending institution has the right to liquidate or retain, in a timely manner, the assets from which the protection derives in the event of the default, insolvency or bankruptcy — or other credit event set out in the transaction documentation — of the obligor and, where applicable, of the custodian holding the collateral"

[3] Art 399 and 401 CRR

[3] See paragraph 13 in the background and rationale section of the consultation: "*Some clarification has already been provided in Article 55 of the Final draft Regulatory Technical Standard on the specification of the assessment*

compliance with the AIRB UFCP eligibility criteria, or, at least, confirm that contract clauses that would be permitted in eligible UFCP under Chapter 4 do not result in UFCP that is "conditional" for purposes of Chapter 3 (the articulation of the prohibition on conditionality in the Dec 2017 Basel III reforms (see paragraph 257) suggests that unconditionality *is* intended to be synonymous with an absence of clauses in the protection contract "outside the direct control of the bank that could prevent the protection provider from being obliged to pay out in a timely manner..." which are prohibited under Chapter 4[4]).

Question 2: *Do you agree with the proposed clarifications on the assessment of legal certainty of movable physical collateral? How do you currently perform the assessment of legal effectiveness and enforceability for movable physical collateral?*

As stated in our introduction, AFME members strongly object to and are concerned by the burden of eligibility requirements set out in section 5 of the paper regarding the legal opinion confirming the legal effectiveness and enforceability of the collateral arrangement in all relevant jurisdictions where the collateral is registered or the jurisdiction in which the owner of the collateral is incorporated. With respect to this requirement, we are aware of the importance of enforceability of the collateral arrangement for movable properties, and we agree with EBA the need to discuss how to ensure it is disposable for the institution. However, in our opinion, the requirement foreseen in paragraph 20 (d) (and the similar requirement in paragraph 21 (b) for collateral for leasing exposures) would require banks to obtain legal opinions from an impractically large number of jurisdictions and its application would heavily penalize important sectors of the economy, such as shipping, transportation and aviation as well as the leasing business and trade and commodity financing. In the case of ships and aircraft for example, these types of collateral and can travel to most (if not all) countries in the world and it would be extremely onerous with respect to both cost and administration to collect legal opinions for every country the assets could be (or usually be) located. Moreover, this requirement would also apply to slightly less moveable assets, such as lorries copiers and medical equipment. The costs associated with obtaining such a large number of legal opinions will most likely be passed on to end users (i.e. exporters and importers).

There are liquid markets for these assets to be sold in the event of default and the costs of taking charge of the assets will be reflected in the recoveries. We recommend the GLs are amended to be commensurate for these forms of collateral so banks are not prevented from recognising them. Noting, if a bank has experienced a situation where it cannot legally take charge of an asset this will be reflected in the historic loss data set used for estimation.

Thus with respect to requiring legal opinions from "all relevant jurisdictions" and in the case of movable collateral from "*the set of jurisdictions where the collateral could move during the lifetime of the loan according to the collateral agreement*", we would ask the EBA to take the following into account:

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methodology for competent authorities regarding compliance of an institution with the requirements to use the IRB Approach in accordance with Articles 144(2), 173(3) and 180(3)(b) of Regulation (EU) No 575/2013 (hereinafter ' RTS on AM')9, not adopted by the European Commission, which specifies that for the purposes of Article 181(1)(f) of the CRR, general consistency should be understood as, or would be fulfilled by, full consistency with the requirements for collateral valuation and legal certainty. In other words, if the institution's requirements are fully consistent with the ones specified in Chapter 4, Section 3 of the CRR for collateral valuation and legal certainty, this would ensure to meet the general consistency requirement of Article 181(1)(f) of the CRR."

[4] See Article 213(1)(c) CRR

- At a minimum, institutions should obtain a legal opinion in the jurisdiction whose law governs the collateral arrangement, opinions from the jurisdictions of incorporation of the obligors also need only obtained in the case of aircraft and ships. Jurisdictions of incorporation as such are normally not relevant for the enforceability of the collateral arrangement, other than for matters relating to the legal capacity of the parties. This does not necessarily need to be covered by way of a legal opinion but can be established in different ways (e.g. checking corporate documents and signature cards). If the obligor itself is the security provider or owner of the collateral, a legal opinion will still be required on the basis of paragraph 20(c).
- It is not contractual market practice to require certain assets (notably ships and aircraft) to be operated or kept (for example in case of traded commodities) within a limited number of jurisdictions. Rather, it is more common to specify in which jurisdictions the asset may not be operated (e.g. by reference to sanctions legislation). The alternative suggested by the EBA that banks evaluate "*the jurisdictions where the collateral is usually located according to the purpose of its use*" may be difficult to establish for an aircraft or ship as it will not usually be located in a single jurisdiction.
- Depending on a case-by-case analysis of the specific transaction, other jurisdictions may be identified as relevant. The most obvious one in case of movable collateral being the jurisdiction where such collateral is located at the time the collateral arrangement is created. This could follow the internationally widely adopted principle of *lex rei sitae* (for example in Article 85(1) of the UNCITRAL Model Law on Secured Transactions). Alternatively, the relevant jurisdiction could be the law of the flag (for ships) or of the State of Registration and, if relevant and different, the habitual base of the secured asset (for aircraft) (although it should be noted law of flags doesn't cover the full scale of movable collateral, e.g. commodities). There is often a registry for the ship/aircraft in those locations and it is market practice to register the mortgage or ownership, of the ship/aircraft on the register. That gives notice of the mortgage/ownership to the world and ensure to the highest degree possible that banks security or ownership is protected from both third parties and the insolvency of our borrower/lessee. Aircraft and aircraft engines often benefit from the protections given to creditors by the Cape Town Convention, an international convention relating to the protection of rights in aircraft and providing for the registration of these rights on International Registry, in Dublin. Ultimately we would urge the EBA to consider options where opinions need not be obtained from all the jurisdictions where the collateral could move during the lifetime of the loan but only from the jurisdiction of the flag of the ship or of the State of Registration of an aircraft and, if relevant and different, the habitual base of the secured asset. Sometimes an additional jurisdiction will be the one of incorporation of the security provider/ owner of the collateral but that's intended to establish its legal capacity rather than enforceability of the collateral arrangement. Institutions are unlikely to obtain legal opinions in "*the set of jurisdictions where the collateral could move during the lifetime of the loan according to the collateral agreement*", unless it concerns a limited number of jurisdictions where the collateral is likely to stay for a prolonged period of time.
- Stopover countries and the flag country are considered less relevant. Typically, in case of oil, institutions would also look at possible security over title documents and the jurisdiction whose law governs the related collateral arrangement would potentially be deemed a relevant jurisdiction as well.
- Should the EBA decide to pursue the proposal for institutions to obtain legal opinions from all relevant jurisdictions we would suggest an impact analysis is undertaken of the materiality of

losses incurred by banks as a result of having not been able to obtain their asset or claim insurance on it. Should the materiality be low, the EBA may wish to consider that the risk is covered as a Pillar 2 residual risk. E.g. if a bank's losses surpass a materiality threshold then it would incur a P2 add-on. An impact assessment should also consider the potential knock-on impact of increased costs on end-users.

- Finally, with regard to specialised lending transactions which would fall into scope of this requirement, we note each case is specific and different. For specialised lending the control of the asset and its cash flows is obtained through the creation of a special purpose vehicle in which the asset and its financing are isolated, lenders having a pledge over the shares of the borrower and either also a pledge over the asset or a negative pledge, i.e. a commitment of the borrower not to give the asset in security to other creditors. This structure reinforces the benefit of a lien over the asset itself. Indeed, these structures are a means of pressure over the shareholders of the SPV owning the asset. These ones would rather positively participate to the restructuring and emergence of the default rather than lose their equity.

Furthermore, re-assessing the legal enforceability of a collateral arrangements in a given jurisdiction for each obligor as required by paragraph 19 of the guidelines seems excessively burdensome and lacks justification in the absence of other changes in the collateral arrangement or applicable legal framework. Substantive variation to the terms of the contract may be better appreciated by exposure class or obligor type. Likewise, a new legal opinion is required where a UFCP arrangement will be used for a different type of guarantor. We would expect that in case there is "a single legal opinion to support multiple unfunded credit protection arrangements" (as referred to in paragraph 23 of the GLs) that confirms the legal effectiveness and enforceability of the UFCP without excluding specific types of guarantors from its scope, there is no need for an additional legal opinion. We would welcome confirmation of this in the final GLs.

Finally, it would be helpful to clarify, in relation to the proposed legal opinion requirements for FCP and UFCP in the consultation (and their SA / FIRB (Chapter 4) equivalents), that the powers of resolution authorities under the BRRD are not regarded as prejudicing the satisfaction of the requirement for legal effectiveness and enforceability (and hence eligibility of FCP or UFCP). I.e. that BRRD-related qualifications in legal opinions (e.g. qualifications where there is a lack of bail-in safeguards for netting/set-off arrangements; qualifications around the lack of bail-in safeguards for UFCP; qualifications re issues for OBSN and certain other arrangements under the BRRD partial property transfer safeguards delegated regulation) are not regarded as problematic. The intention would presumably not be to prejudice the ability of EU institutions subject to BRRD powers to act as protection providers.

Question 3: *Do you agree with the proposed clarification regarding the calculation of realised LGD on exposures covered by eligible on-balance sheet netting or master netting agreements?*

The draft Guidelines confirm OBSN should be recognised in the 'exposure value' also known as EAD. Paragraph 26 further describes recognition in accordance with the Financial Collateral Comprehensive Method (FCCM) under CRR Article 228(2). This article contains a formula to adjust LGD (LGD*) based on the exposure value (EAD) before and after the effects of collateral. We recommend the EBA amend the wording of the Guidelines to clarify that the effects of OBSN cannot be recognised in LGD estimates but it should still be recognised via LGD using the FCCM under Article 228(2); and that the 'exposure value' (EAD) used in the calculation of RWA should not be reduced by the OBSN to avoid double counting the netting benefit.

In addition, the Corep templates for Standardised and IRB approach requires the reporting of exposures gross of OBSN, this should be consistent with paragraph 14.

Question 4: *Do you have specific concerns related to the recognition of collateral in the modelling of LGD? How do you currently recognise collateral in your LGD estimates?*

The requirements do not reflect a commercial recoveries process where a customer-level approach is followed. To clarify, a bank may take a package of security when lending to a client. Some of this collateral may not meet all of the eligibility criteria for credit risk mitigation under CRR Part three, Title II, Chapter 4 but the bank's recovery process will still seek to make the maximum recovery using all collateral. Where a customer level approach is being used it is unnecessarily complex to separate recoveries for each individual type of collateral, whether eligible or ineligible and does not reflect the commercial reality.

We would also welcome further clarification regarding the treatment of collateral under a guarantee. While we understand the CRR to be clear in the case of synthetic securitisations where Article 249 cross references directly to Chapter 4, we are not sure how we should treat the collateral on untranched guarantees (i.e. not securitisations). Could the EBA confirm which articles drive the level of asset haircuts that should be applied to bonds (i.e. chapter 3 or chapter 4?).

The guidelines on PD LGD estimation require banks to fully identify the cash flows related to the collateral so as to reflect the effect of the collateral on the basis of the institution's own recovery experience and data. However, they do not prescribe any specific method to model the collateral effect on realized LGD and do not require the effects of a given type of collateral to be assessed separately for each application scope of LGD models/obligor type. There is indeed to our knowledge no strong evidence that the liquidation value of a given collateral or repossession costs are strongly related to the identity of the obligor or even to the obligor type or the exposure class (yet it should be noted that specialised lending structures aim to facilitate the collateral security enforcement and control of cash flows generated by the collateral). We would like the EBA to confirm this lack of restriction for modelling the recovery on the collaterals and to clarify that "ability to recognize a funded credit protection in the estimation of the LGD of comparable exposures to the guarantor" does not "require to find an exposure to the guarantor which is collateralized by the same collateral as the original exposure" as indicated in Section 5.1.C of the guidelines. Such an interpretation would be unduly restrictive in light of the modelling options defined in the guidelines for PD/LGD estimation and empirical evidence related to the recoveries on collateral. More importantly, considering the provisions of article 39 of the present draft guidelines, it would mean AIRB Banks would not be able to recognise UCP on most specialised lending exposures benefiting also from FCP, thereby discouraging them to take guarantees or credit insurance, as:

- Obligors in this scope are often SPVs, whereby unsecured LGD can only be higher than that of guarantors (be them credit insurers or corporate guarantors)
- Loss experience on exposure to guarantors secured by the very same type of collateral is limited in case of collaterals of a very specific nature meaning of a nature highly related to the core activity of the obligor.
- The approach defined in article 39 is to be applied for computing the "RW floor" derived from the articles 161 (3) et 164(2) of the CRR

- Notably, lenders can benefit from insurance policies on aircraft finance loans. Yet there are probably very few data on defaults and losses over insurances policies coupled with aircraft in security. As the lenders still have access to the aircraft as long as the insurer has not fully indemnified them (on the insured part of the loan), the lenders can benefit from the recoveries over the aircraft (proceeds of the sale). These recoveries from the aircraft are independent from having also an insurance policy, and the modelling of the asset recoveries should not be impacted by the existence of the insurance.

Finally, we are concerned by the future impact on recognition of collateral in the modelling of LGD. The application of Input floor and haircut on AIRB models proposed within the Basel III revision framework is overly punitive, as the formula used to determine the floor considers the haircut according to the comprehensive approach (under the foundation approach), hence leading to increasing capital absorption despite better quality collateral.

Question 5: *What approaches for the recognition of the unfunded credit protection do you currently use? What challenges would there be in applying approaches listed above for the recognition of unfunded credit protection?*

The proposal to treat defaulted, guaranteed exposures as non-defaulted in terms of RW and ELBE is complicated as it is necessary to goal seek to the LGD in default from the non-defaulted RW and PD of the guarantor. This means pre-calculating the RW for the guarantor before the LGD in-default can be calculated which is a reversal of the common process banks use i.e. calculate LGD first and use this to calculate RW.

Paragraph 29 of the draft Guidelines also states that substitution means substituting the PD and LGD of the institution and that where the guarantor is only permitted to use the FIRB approach the regulatory LGD of an equivalent exposure should be used. However, in complying with CRR article 161(3) it is unclear if the maturity of the equivalent direct exposure be 2.5 years, as required under CRR Article 162(1), or instead the obligor's AIRB maturity can be used to the calculate the risk weight floor. We recommend the EBA clarifies this in the final GLs.

Additionally, para 30 is inconsistent with Corep Template C09.01 which requires banks to re-assign such exposures to the exposure class of the guarantor. In the public hearing, the EBA confirmed this paragraph is related to the estimation process, not applicable for reporting purposes and that the reporting will not be modified. We suggest the inclusion of a clarification in the text about what is meant by exposure class and that it only impacts the estimation process and not the reporting process. The EBA may more generally want to consider the value of preserving the three approaches for UFCP if the aim is to increase comparability between banks. Given the various options and the complexity related to the substitution approach (on computing realized LGD etc), it may not present much of a value-add.

Finally we would like further clarity when it comes to unfunded credit protection and rating transfer, to the link existing between section 6.2 of the draft guidelines and section "5.2.3 Treatment of ratings of third parties", par. 62 of "Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures" (EBA/GL/2017/16). It is not clear if the PD "substitution approach" in the draft GLs is considered to be equivalent to the rating transfer approach (EBA/GL/2017/16) and, if so, if the eligibility requirements for the CRM purposes (EBA/CP/2019/01) are considered to be equivalent to the appropriateness requirements for the rating transfer purposes (EBA/GL/2017/16).[5] In our view the process of rating transfer should prevent any fully consolidated and controlled subsidiary from being granted a lower risk rating than its consolidating parent company, as there is no difference in risk between such counterparties. Therefore, when the consolidating parent company has a low credit standing with a high PD, its subsidiary should be given the same creditworthiness level through the "rating transfer" approach. On the other hand, the application of the credit risk mitigation techniques through the PD and/or LGD substitution between Guarantor and Guaranteed would result only in a reduction of the risk profile of the Guaranteed counterparty (otherwise, the PD and/or LGD substitution is not applied, keep its stand-alone rating grade).

Additionally, we'd note that the qualification of "organizational relation" (e.g., the strong connection between a Parent company with its fully consolidated and controlled subsidiaries) in par. 62 of EBA/GL/2017/16 would be qualified as an "appropriate" guarantee, thereby supporting the rating transfer. Should not this be the case, par 62 of EBA /GL/2017/16 would prove of a very limited use in actual practice.

The process of rating transfer should prevent any fully consolidated and controlled subsidiary from being granted a lower riskiness than its consolidating parent company, as there is no difference in risk between such counterparties. Therefore, when the consolidating parent company has a low credit standing with a high PD, its subsidiary should be given the same creditworthiness level through the "rating transfer" approach. On the contrary, the application of the credit risk mitigation techniques through the PD and/or LGD substitution between Guarantor and Guaranteed would result only in a reduction of the risk profile of the Guaranteed counterparty (otherwise, the PD and/or LGD substitution is not applied, keep its stand-alone rating grade).

Furthermore, we'd note that the qualification of "organizational relation" (e.g., the strong connection between a Parent company with its fully consolidated and controlled subsidiaries) in par. 62 of EBA/GL/2017/16 would be qualified as an "appropriate" guarantee, thereby supporting the rating

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[5] based on the section "5.2.3 Treatment of ratings of third parties", **par. 62** of "Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures" it is stated that: *"Institutions should have **clear policies** specifying the conditions under which the rating of a third party who has a **contractual or organizational relation** with an obligor of the institution may be taken into account in the assessment of risk of the considered obligor".*

Following this, the EBA lists the possible manners in which the rating of such a third party may be taken into account in the assessment of risk of the considered obligor. In particular, **under par.62(a)** the EBA requires that: *"…the rating of such third party being transferred to a relevant obligor ('**rating transfer**'), where there is no difference in risk between the obligor and the related party because of the existence of an **appropriate guarantee and the rating of a third party is assigned internally** in accordance with the rating system for which the institution has received permission in accordance with Article 143(2) of Regulation (EU) No 575/2013".*

According to the above, a prerequisite for "rating transfer'" is "the existence of an appropriate guarantee". What par. 62 implies is that while it is on the intermediary to specify the conditions of a clear policy on the use of the rating of a third party in the assessment of risk of the considered obligor, the guarantee required for risk transfer **has to be "appropriate".** Therefore, **it does not need to be "eligible" under Article 183 of Regulation (EU) No 575/2013** and, as a consequence, the definition of the "clear policy" set by the institution should also include and support a definition of "appropriate" guarantee.

transfer. Should not this be the case, par 62 of EBA /GL/2017/16 would prove of a very limited use in actual practice.

Question 6: *Do you have any specific concerns related to the issues excluded from the scope of the Guidelines?*

In our view, the clarification of the CRM approaches which these draft Guidelines are aimed at providing should be considered jointly with the changes related to the finalization of Basel III to avoid excessive model volatility within a very short timeframe. This joint approach is also needed to better assess the final impact of the changes introduced by both the revised Basel III framework and the present draft guidelines. We are especially concerned by the fact that: i) credit insurers will fall under the F-IRB approach under the revised Basel III framework, with a 45 % LGD; and ii) the article 39 for the present Draft Guidelines prescribes to apply Part Three, Title II, Chapter IV requirement both to compute the "RW floor" derived from the articles 161 (3) and164 (2) of the CRR and to apply the substitution approach. In our view, these 2 categories of provisions should be considered jointly as they will discourage the subscription of credit insurance on a wide range of secured IRB-A exposures. We would recommend both to better recognize the specificity of insurance exposures in the LGD values prescribed by the regulation or to maintain the IRB-A approach for exposures to credit insurers, and to confirm that collateral effects can be assessed independently of the identity of the obligor and reflected as such at the comparable exposure level.

The European authorities should further consider the impacts of the changes introduced in the scope of application of the existing rules under Basel III. In the revised framework there are still differences between the standardised and the IRB approaches in the collateral that can be used as credit risk mitigant. For instance, physical collateral is not considered as an eligible CRM technique under the standardised approach while it is eligible under the IRB. Another issue (which may be better tackled within the scope of the Call for Advice) is the differentiation one should make between various types of CRM and especially insurance policies used as a CRM tool.

The revised Basel framework also introduces limitations in the assessment of collateral under the advanced approach. Essentially banks are encouraged to apply the standardized and FIRB parameter to the collateral evaluation even under the AIRB approach. Indeed, the only eligible collateral are that for which the effects on the LGD are possible to model. We underline that for specialised lending, there are deep databases of aircraft values or ship values, provided by external appraisers (like Flight Global or ASG for the first ones and Clarkson or Drewry for the second ones). These databases enable banks to build solid LGD models which are back-tested annually through a comparison of estimated LGD and actually observed historical LGDs. The fixed foundation haircuts to be applied to LGD floors are in contradiction with the permission provided for in the revised Basel III for banks to continue using internal models as the purpose of these models is precisely to assess internal haircuts. The reference to the foundation eligibility criteria in AIRB is also counter to other parts of regulation regarding requests for own estimation of LGD, notably regarding liquidity and the degree of which should be taken into account in A-IRB. Liquidity is therefore not a pre-requisite for taking the asset in collateral in the recoveries in A IRB, but the degree of liquidity should be taken into account in A-IRB. The eligibility criteria were designed for corporate loans and not for specialised lending and should therefore be adapted to the A-IRB in order to be consistent with this approach (n.b for specialised lending recoveries are provided not only from the sale of the collateral asset, but most of the time from the cash flows of the asset and the emergence of the default through a restructuring of the loan -e.g. postponement of maturity/extension of the lease to the existing operator or new lease with another counterpart).

Furthermore, we would support aligning the approach as much as possible to the GL on PD and LGD and on Downturn component, especially considering the Basel 3 framework on Input floor and haircut on AIRB models: the downturn component potentially double counts the effect derived by the implementation of not negligible floors to the LGD (both secured and unsecured post collateral haircut application are already very punitive).

Regarding the LGD floor imposed to the secured part of the exposure, aimed at embedding in the model the risk of reduced realizable value of the collateral, this double counts both the effect of the regulatory and internally estimated haircuts. In addition, as far as the unsecured portion is concerned, the LGD estimate already considers the downturn effect. Consequently, this would lead to higher haircuts and floors which also double-count stressed scenario variables which have been already considered in the LGD estimates.

We also consider there is need for clarity on the use of how to take into account UCP for the supervisory slotting approach. The CRR is silent on whether UCP (other than those already specified in the slotting approach like completion guarantees or guarantees provided by public entities in PPPs), can be recognised for specialised lending exposures treated under supervisory slotting. The EBA's slotting guidelines also do not take into account the treatment of additional guarantees, i.e. other than those already specified in the slotting approach, such as those provided by Export Credit Agencies for political and commercial risk or insurance policies covering the risk of a loan. Regarding ECA guarantees that effectively convert the guaranteed exposure to ECA or sovereign risk - how can their impact be reflected in the slotting approach, when the framework allows this to be done only through PD and LGD adjustments, and under the slotting methodology there is no PD/LGD to adjust? This anomaly could potentially be adjusted by either tranching the exposure in the context of ECA guarantees and risk weighting the guaranteed portion per the PD and LGD of the eligible guarantor, and using the Slotting risk weight for the uncovered portion and by revisiting the granularity of the of the slotting approach to allow for other risk mitigation to be reflected better in the risk weights. We note that in footnote 3 of the high level summary of the Basel III reforms the Committee that will review the slotting approach for specialised lending in due course, we welcome early clarity on when this will take place and urge the EBA to engage on any such review and consult industry in the process.

Question 7: *Do you agree with the proposed clarification regarding the parallel treatment of ineligible UFCP and ineligible FCP? How do you currently monitor the cash flows related to ineligible unfunded credit protection and how do you treat such cash flows with regard to the PD and LGD estimates?*

Generally, our members considered the ineligible guarantee treatment is complex, difficult to apply in practice and does not reflect the commercial recovery process.

We would specifically welcome clarity on the following:

- "Unfunded credit protection which does not meet the eligibility requirements […] should not affect the calculation of risk-weighted exposure amounts […]" – is it to be understood from this wording that despite these guarantees being ineligible, CRM can still be applied since the calculation of the RW is not affected?

- "The cash flows received from exercising the ineligible unfunded credit protection should be treated as if they had been received without the use of unfunded credit protection" – could the EBA confirm how the cash flow is to be treated instead? We consider that the cashflows should be allowed to be included with unsecured recovery cashflows.

Question 8: *Do you agree with the proposed rules for the application of the substitution approach? Do you see any operational limitations in excluding the guaranteed part of exposure to which substitution approach is applied from the scope of application of the LGD model for unguaranteed exposures?*

It is not clear whether the substitution approach can only be applied if the execution costs are expected to be negligible. We suggest clarifying the following sentence in the final guidelines: "*the institution may reasonably expect that the direct costs of exercising the unfunded credit protection are negligible with respect to the amount covered by the unfunded credit protection*." Indeed, paragraph 36 of the draft Guidelines introduces as a condition to use the substitution approach is that the direct costs associated with exercising the guarantee are negligible with respect to the amount covered. This condition doesn't apply to Foundation IRB banks / exposures and creates an inconsistency where the availability of the substitution approach differs between FIRB and AIRB banks. We recommend that the substitution should still be available in these circumstances but that the value of the guarantee be haircut for the direct cost to reduce the amount of benefit recognised.

Furthermore, in respect of the two options presented in the CP, our members are of the view that both options should be retained so as not to limit banks practices. There may be certain cases where banks choose to apply option 1 over option 2 and we think there is no benefit to limiting this, where necessary and appropriate banks should be able to justify this to their supervisor. Nonetheless, option 2 generally reflects bank practices as the more applicable and in line with the contractual agreements in place.

As a general comment in relation to the effects of UFCP, it is not wholly clear whether the parts of the consultation dealing with the credit risk mitigation effects of FCPs and UFCPs which cover the same part of an exposure (see paragraphs 34(a) and 39 of the draft guidelines) are intended to cover the situation where FCP is provided on UFCP – i.e. collateralised guarantees. In the context of collateralised guarantees, collateral is provided in respect of the guarantee obligation (the UFCP) rather than in respect of the underlying exposure, however, the consultation only explicitly refers to exposures which benefit from FCPs. Recognition of collateralised guarantees under the IRB approaches is clearly envisaged by the Basel provisions from which the CRR derives (see paragraph 303, 2nd bullet and paragraph 307 of Basel II). Clarification of this point would be welcome, as would clarification that the risk mitigating effect of collateralised guarantees can be recognised under the SA (i.e. that, after substituting the risk weight of protection provider for the risk weight of the underlying exposure subject to satisfaction of the UFCP eligibility criteria in relation to the underlying exposure, the risk weight of the guarantee collateral can be substituted for the risk weight of the protection provider subject to satisfaction of the collateral eligibility requirements in relation to the guarantee). There is no obvious purposive reason why this should not be permitted and the point, hopefully represents a clarification only.

Question 9: *Do you agree with the proposed rules for the application of the modelling approach?*
N/A

Question 10: *What challenges would you envisage for back-testing the substitution approach? Do you agree that the back-testing should be performed rather at Expected loss level? Do you have any approach currently in place for the back-testing of substitution approach?*

The article 179(1)c of CRR requires that "institutions shall review their estimates when new information comes to light but at least on an annual basis" in quantifying risk parameters. The review tackles the estimates of credit risk parameters. The notion of "back-testing the substitution approach" therefore does not appear to have a legal basis in the philosophy of rating systems embedded in CRR. The current approach in place within banks for the backtesting of credit risk parameters (applicable for guarantors and obligors) ensures that the estimates stay robust to additional historical data, and therefore is compliant with CRR.

Question 11: *Do you agree with the proposed guidance for the estimation of the LGD of comparable direct exposure towards the guarantor? What concerns would you have about the calculation of the risk weight floor?*

We do not agree with all of the proposed guidance for the estimation of the LGD of comparable direct exposure towards the guarantor, in particular paras 39(a) and 39(b) do not appear consistent.

We support the requirement of consistency for the application of the substitution approach, according to which: "*splitting the part of the exposure covered by a given unfunded credit protection in two parts and applying to one part the 'substitution approach' and to the other part the 'modelling approach' should not be allowed*". Moreover, we deem important to establish what is the appropriate criteria to choose or which unfunded credit protection to use for the purposes of substituting the risk parameter in case of multiple unfunded credit protections that cover the same part of the original exposure. Nevertheless, in the same case, we would have some concerns on the feasibility to satisfy the requirement foreseen by article 37.C related to the calculation of risk weight floor where the original exposure benefits from multiple unfunded credit protection and where two or more are providing protection to the same part of the original exposure. Specifically, in case of multiple unfunded credit protection on the same part of the exposure it is not clear the criteria to use for the calculation of each risk weight direct exposures to the guarantor, for instance whether the effect of the other existing unfunded credit protections should be considered on the same part of the exposure (in accordance with paragraphs 40) or not. We would therefore recommend adding more detail in the final guideline in order to better explain how to consider the effect of credit mitigation in these cases. In this respect, attempting to adjust the LGD of one guarantor for other(s) covering the same exposure would be overly complex and banks would prefer to take a conservative and simple approach in recognising one guarantor via substitution. At the public hearing the EBA confirmed banks are not required to take the benefit for additional UFCPs covering the same exposure in CRM, and can utilise CRR Article 3, which does not 'prevent institutions from holding own funds and their components in excess of, or applying measures that are stricter than those required by' the CRR. Indeed, the EBA may wish to potentially consider simpler approaches where there are multiple exposures.

We also think the particular case of insurance policies used as CRM tool which in our opinion warrants a enhanced LGD compared to that prescribed in the Foundation approach or indeed observed in direct exposure instances. In this particular case, indirect exposure is in fact more beneficial than direct for all the reasons which set insurers apart from banks: claims from policyholders benefit from senior creditor status as a result of multiple protections: ringfencing of assets of the insurer to secure outstanding liabilities at the operating level; priority ranking of policy holders under the Solvency 2 Directive, regulatory requirements to further provision for potential claim liabilities; and the Insurance Guarantee Scheme that functions as a backstop to the regulations - all of which are reflected by the external ratings for the insurance entities writing insurance policies (Insurer Financial Strength Rating) vs. the insurance entities that take on debt as creditors (Issuer Default Rating). As noted in the Fitch Recovery Rating scale[6], recovery rates for policyholders could be expected to be well above the recovery rate implied by the 45% LGD floor currently prescribed for financial institutions including insurance companies. Insurers are not involved in maturity transformation (unlike banks) and are not exposed to sudden losses of confidence or 'runs' and most multi-line insurers are uncorrelated to the credit cycle. Furthermore, in relation to insurance policies, the GLs do not address the interpretation of the word "comparable" in the definition of risk weight floors: for instance if the transaction benefits from other security, it is not clear if a comparable transaction would be then by consequence a secured transaction. Similarly, "comparable" is often interpreted as a bank lending to the insurer when in fact they are a policyholder. The current framework does not envisage a policyholder position, which is privileged and senior to that of an unsecured creditor. Our concern is that the proposed 45% prescribed LGD for insurer exposure under the final Basel III reforms is not reflective of the reality of that specific CRM tool as it will result in substitution of much higher risk weights and potentially a reduction in lending volumes and trade facilitated by this important tool.

Regarding paragraph 39 a) and b) we underline that in case of a loan where the lenders benefit from an asset in collateral **and** an insurance policy, the lenders keep full access to the collateral as long as the insurer has not fully indemnified them. The benefit of the insurance policy is independent of the benefit of the asset as collateral. Therefore, the methodology to assess the RW on the insurer should not affect the approach for modelling the asset recoveries. When these are assessed by an internal model, the banks should have the option to use the LGD based on that model in the RW calculation, if lower than the insurer LGD, and the PD of the insurer could also be taken into account as there would be a default on the insured loan only in case the insurer defaults regarding the insurance policy. This approach reflects the real risk where lenders both have an insurance policy and an asset as collateral. If the insurer does not default regarding its insurance policy, lenders are fully indemnified. Otherwise, lenders still have their asset in collateral. Therefore, we don't see the logic of paragraph 39 a). Providing insurance policies enables banks to go on financing large parts of the economy. Paragraph 39 a) would strongly reduce the efficiency of banks' risk management by banks and harm economic growth.

Regarding paragraph 39 b), in the case of a loan benefiting from both an insurance policy and an asset as collateral, there would be very few instances of defaults with both insurances policies and asset in collateral, and almost no direct loan to an insurer with an aircraft in collateral for example - operating such assets are not in the scope of activity of insurers. As explained above, the recovery of the asset is independent from the benefit of the insurance policy and the LGD calculated in IRB with that asset in collateral should be kept, particularly in the case of specialised lending.

Moreover, the condition introduced in paragraph 39 b to check if "the LGD of direct exposures to the guarantor which do not benefit from any form of CRM is lower or equal to the LGD of direct exposures to the obligor which do not benefit from any form of CRM" will be a strong issue when applying Basel IV as financial institutions will receive a 45% LGD which will be in most cases higher that the LGD for

[6] Fitch Insurer Rating Criteria, 11 January 2019, p.106: https://www.fitchratings.com/site/re/10058790

unsecured Corporates. Therefore, the condition will never be fulfilled, and banks will not be able to use the LGD estimates of the original exposure to the obligor including the effect of the funded credit protection. Therefore, the most accurate treatment will be to use the LGD secured applicable to the obligor taking into account the funded credit protection.

Question 12: *Do you consider portfolio guarantees as a form of eligible UFCP? Do they include cases where the guarantee contract sets a materiality threshold on portfolio losses below or above which no payment shall be made by the guarantor? Do they include cases where two or more thresholds (caps) either expressed in percentages or in currency units are set to limit the maximum obligation under the guarantee? How do you recognise the portfolio guarantees' credit risk mitigation effects in adjusting risk parameters?*

In the public hearing, the EBA re-confirmed that any transactions meeting the securitisation definition as per Art. 4 must be handled by Chapter 5. Should the EBA include a section on 'portfolio guarantees' in the final GL, we suggest the inclusion of a clarification regarding this in the text (CRR is clear in this respect).

As a general comment, we would point out that the UFCP schemes described in the draft guidelines, shall operate and be used both on STA and A-IRB portfolio. The effect of the UFCP should indeed be independent of the eligibility rules applicable on the guarantor, and we recommend allowing the adjustment of the relevant parameters in case of both STA and IRB underlying portfolios.

Discussion, in the consultation, of Art 234 CRR (see the last para on p 47 and the first two paras of p 48[1]) could be taken to imply that, under the SA and FIRB, UFCP involving horizontal credit risk tranching results in calculation of RWEAs under Chapter 5 of the CRR whether or not the transaction constitutes a "securitisation" within the meaning of the Art 4(1)(61) CRR (and Art 2(1)(c) STS Regulation). We do not believe that the article is commonly understood in this way (i.e. the provisions of Chapter 5 relate to "securitisations" and are therefore not regarded as "biting" unless a transaction constitutes a securitisation). The securitisation definition contains a number of explicit limitations/exclusions. Structures involving horizontal credit risk tranching will, notably, not amount to "securitisations" where: (i) a physical assets exclusion applies (see Recital 50 of the CRR, Recital 6 of the STS Regulation and new limb (c) of the "securitisation" definition, which cross refers to Article 147(8)(a) CRR); or (ii) the junior and senior tranches rank pari passu during the life of the transaction and subordination kicks in only on liquidation / administration of the borrower (in which case, the PD of the junior and senior tranches would be expected to be same (though their LGD would differ)) due to the

[1] "The CRR provisions applicable for the first and second cases described above may include Article 234 of the CRR on partial (pro-rata) protection. In particular, this Article clarifies that where an institution transfers a part of the risk of a loan in one or more tranches, the provisions on the securitisation framework as set out in Part Three, Title II, Chapter 5 of the CRR shall apply. Moreover, it also specifies that institutions may consider materiality thresholds on payments below which no payment shall be made in the event of loss to be equivalent to retained first-loss positions and to give rise to a tranched transfer of risk. However, this Article is not directly applicable to exposures treated under A-IRB. Within Chapter 3 of the CRR there is neither any equivalent article. allowing the treatment of partially protected exposures as being assimilated to tranched/securitisation positions, nor are there any cross-references made to Article 234 of the CRR. Under the A-IRB according to Article 109 of the CRR, Chapter 5 is applicable for exposures classified as securitised exposures according to Article 147(2)(f) of the CRR. In this regard, in order for exposures that are covered by a "portfolio guarantee" to qualify as securitised exposures the portfolio guarantee transaction would have to meet the definition of securitisation given in Article 4(1), point (61) of the CRR. **If the exposure is treated under the SA or F-IRB and the institution could apply any LGD adjustments, the only option for the institution to recognise portfolio guarantees is to apply Chapter 5 in accordance with Article 234 of the CRR.** If the exposure is under the A-IRB, in principle, institutions could be able to recognise the CRM effects of portfolio guarantees through LGD adjustments."

requirement for loss sharing during the "ongoing life of the transaction" in limb (b) of the securitisation definition. The physical assets exclusion(s) would have tightly circumscribed relevance in this context, given: (i) the requirement for funding to be provided (funded CLNs could be relevant, though – in terms of calculation mechanics – directly issued CLNs are, analysed as cash collateral (FCP) under Art 218 CRR rather than as UFCP); and (ii) in the case of exemption under limb (c) of the securitisation definition (though not Recital 50/6 to the extent that this constitutes a separate exemption) use of an SSPE is required (though recognition of UFCP could still be relevant on a consolidated basis for a prudentially consolidated SSPE). The exemption relating to distribution of losses "during the ongoing life of the transaction or scheme", however, is entirely relevant in this context. Interpretation of Article 234 CRR as requiring compliance with Chapter 5 irrespective of "securitisation" status would, in effect, render the exemptions to the securitisation definition meaningless in a synthetic context. Chapter 5 contains a requirement for originators to demonstrate significant risk transfer in order to recognise credit protection (Art 245, 251 CRR) as well as, effectively, importing the STS regulation requirements wholesale where the holder of a position wishes to benefit from the more favourable RWEAs for STS securitisations and specified SME transactions. It would be out of line with the market's understanding of the regulatory position for e.g. a funded CLN funding the acquisition or operation of physical assets through a consolidated SSPE (i.e. within a physical asset exclusion) to have to comply with these requirements.

The same considerations (the need to protect the exclusions from the securitisation definition) apply in relation to the AIRB approach.

Incidentally, we note that in the Basel discussion of materiality thresholds in relation to UFCP on the SA and FIRB (both under the current rules (see para 197) and under the future rules post the December 2017 reforms (see para 201)) such thresholds are required to be treated as retained first loss positions and deducted in full, but there is no cross-reference to the securitisation framework.

Further comments on other aspects of the EBA CP:

Implementation: We consider the implementation of these GLs should be aligned with the implementation of Basel III, as should the outstanding IRB repair work. Furthermore, a mapping regarding the articles relating to the key areas of Credit Risk Mitigation (e.g. currency mismatch, maturity mismatch, collateral haircuts, etc) applicable to SA, F-IRB and A-IRB would be well received.

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