EBA Consultation Paper
EBA Draft Regulatory Technical Standards
on benchmarking portfolio assessment standards and assessment sharing procedures under Article 78 of Directive 2013/36/EU (Capital Requirements Directive – CRD IV)

and
EBA Draft Implementing Technical Standards
on benchmarking portfolios, templates, definitions and IT solutions under Article 78 of Directive 2013/36/EU (Capital Requirements Directive – CRD IV)

Introduction

The British Bankers' Association ("BBA") is the leading association for UK banking and financial services for the UK banking and financial services sector, speaking for over 220 banking members from 60 countries on the full range of the UK and international banking issues. All the major banking players in the UK are members of our association as are the large international EU banks, the US banks operating in the UK and financial entities from around the world. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment banking and wealth management, as well as deposit taking and other conventional forms of banking.

The BBA is pleased to respond to this consultation on the draft RTS and ITS.

The BBA is supportive of the comments set out in the EBF and the combined afme and ISDA responses.

Yours faithfully

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Background- A summary of the EBA approach

The conceptual approach set out by the EBA is to collate data on the IRB portfolios, and then begin by analysing the outcomes i.e. the Own Funds Requirements or the Risk Weighted Assets.

We pleased to read in the RTS Recital (11) that:

> *in addition to assessing banks' observed regulatory own fund requirements obtained from authorised models, competent authorities shall assess the overall 'quality' of the internal models as well as the degree of variability observed in particular approaches.*
>
> *Accordingly the competent authorities' assessment should not focus solely on internal approaches' outcome; the analysis should aim to determine the key variability drivers and to extract conclusions regarding the different modelling approaches and options that institutions contemplate in their internal models.*

However, in the same recital it sets out that it considers that its primary objective is to focus on compliance with Article 78 (3)

> *At least annually, competent authorities shall make an assessment of the quality of those approaches paying particular attention to:*
>
> a) *those approaches that exhibit significant differences in own fund requirements for the same exposure;*
>
> b) *approaches where there is particularly high or low diversity, and also where there is a significant and systematic under- estimation of own funds requirements.*

Accordingly the recital (11) concludes:

> *Hence competent authorities should be required to take into account, in the course of their assessment, of the results of the back-testing performed by institutions or of the related analyses contained in the EBA report referred to in the second subparagraph of Article 78(3) of Directive 2013/36/EU.*

The proposed EBA approach is to a) define extreme values by categorising outcomes from all risks into quartiles and b) compare these outcomes with 80% of the Standardised Risk Weights.

Their logic is that they consider that it is outputs i.e. RWAs and the identification of institutions in the first and fourth quartiles as well as deviation from standardised risk weights that are the signals of possible underestimation of the OFR.

The EBA also proposes to compare 1 year and 5 year average outturns i.e. a comparison of the actual losses and number of defaults with the predicted - i.e. the expected values - and from these differences to be able deduce whether under estimations of the OFR are likely.

The EBA will also compare the modelled values (risk drivers) as well as the OFR at obligor, pool (clusters) and portfolio level for actual or even for hypothetical transactions.

We have noted that the EBA proposes to augment the assessment of the OFR by collecting a limited set of supplementary data to enable the assessment of the drivers of some modelled values (Annex IV, V and VI).

Summary observations

We recognise that the assessment of the Own Funds Requirement (OFR) or Risk Weighted Assets (OFR x 12.5) is a significant contributory factor to the adequacy of capital. However, it is not the only assessment that is required to determine if an institution has the appropriate level of Core Tier 1 Equity. We recognise the EBA is required to comply with the Directive, however, we believe that the EBA has a duty to ensure that competent authorities take into account many other factors when assessing whether or not the OFR is appropriate.

The reasons why the calculation of the OFR for each obligor, facility, transaction and account can vary and or conversely can be the same for the same and different risk or equivalent or dissimilar portfolios in different institutions using the IRB approach have been documented in recent years within a number of studies and published by the Basel Committee, EBA, EBF, competent authorities and commentators.

The RTS indeed includes in Article 8 examples of legitimate reasons why differences can exist for Credit Risk. The primary factors that drive the Credit Risk OFR are:

1. **Institution's approach:** The models that each institution have adopted to determining the risk drivers for each exposure within each asset class and portfolio namely the Probability of Default, Loss given Default, Exposure at Default and determination of maturity.

2. **Supervisory policy**: The mandatory modelling standards that an institution must follow including definition of default, discount rates, observable periods required for modelling, overrides, floors use of IRB Foundation, scaling parameters and model approvals etc. that change the values that have been determined by an institution.

3. **Country (or EU-wide) specific** economic, legal and accounting factors that have effects upon the classification of default, cross default, inability to enter default, ability to and the time taken to recover collateral and or extinguish a debt etc.

4. **The IRB Formula**: The way in which the formula – defined by the Basel Committee on Banking Supervision – that is PD dependent by asset class scales up the expected loss into a total loss and then deducts the EL to derive an Unexpected Loss means that UL cannot be assessed in isolation without assessing EL and also comprehending the risk profile that results in risk densities (average RW %) that are heavily influenced by the skew of EaD within each portfolio as well as idiosyncratic PD rating bands established by each institution.

It is acknowledged that it is possible that within the complete range of internal approaches to modelling the risk drivers for there to be outliers that require further investigation in order to ensure that an institution has not chosen an approach that either purposely or inadvertently results in an under-estimation of the OFR relative to peers.

That is why the BBA is entirely supportive of the content of and the objectives set out in Articles 78 of the Directive that requires to the EBA to <u>assist</u> competent authorities to assess the OFR.

Nonetheless, we are not yet convinced that the approach set out in the RTS and ITS will enable competent authorities to comply with the requirements set out in the directive and or to achieve their objective based upon the information set out by the EBA in Annexes I through IX and or avoid the outcomes set out in Article 78 (5).

Summary Comments regarding the EBA approach to the assessment

We have set out this summary as well as repeating the key points in answers to the questions so that recipients can read a response that sets out the key themes. Had we only responded to the questions we do not think it would have been possible to address all issues, because there are many matters that the EBA does not ask any questions, but nonetheless are important in order to provide comment upon whether or not the the objectives of the Directive will be achievable. The summary points are primarily focussed on the assessment of the IRB approach to Credit Risk. Specific comments on Market Risk are included in the answers to the questions.

The need to focus on inputs and outputs

1) The EBA has chosen to conduct the assessment by focussing its assessment on the outputs i.e. the OFR (RWAs). We believe that the EBA is placing an inappropriate focus on the outputs and thus is starting from the wrong point.

   In particular we are concerned that after taking into account the combined effects of the four factors listed above - that drive the Credit Risk OFR (RWAs) - that insufficient attention has been paid by the EBA to collect data to identify differences and or similarities in the drivers of credit risk.

   We encourage the EBA to establish a more proportionate approach that focuses more on the benchmarking of the inputs and the modelling of them instead of solely outputs. This may need a review of the data collection process. We encourage the EBA to be mindful of the operational workload upon institutions when requesting such data.

2) We do not believe that by looking at the outputs in isolation that any meaningful conclusions can be derived with respect to an underestimation, appropriate estimation or overestimation of the OFR or RWAs. The capital adequacy of an institution includes many other considerations that take into account actual and or perceived shortfalls or excesses in modelled losses derived from the IRB approach.

   We believe that the EBA should draw competent authorities' attention to the need for an overall assessment that includes all pertinent information that is in the possession of each competent authority. Otherwise a focus solely on the OFR could in fact have the opposite effect than required by the Directive. It is important that benchmarking does not lead to standardisation and a herd mentality by institutions that may drive them to change risk profiles to hide themselves from being an outlier.

3) We recommend that

   a. The starting point and priority should be the assessment of and comparison of the <u>quality</u> of internal approaches to modelling the Credit Risk drivers, specifically for Credit Risk, PD, LGD, EaD and Maturity.

   b. The focus should be on collating the data that underpins the modelling approaches in a systematic manner that encompasses the differences in modelling choices, examples of which are set out in RTS Article 8 and 10 and as mandated by the Directive in the second sentence of Article 78 (1) *Institutions shall submit the results of their calculations, together with an explanation of the methodologies used to produce them, to the competent authorities at an appropriate frequency, and at least annually.*

c. Templates should be developed to collect information on the internal model validation results, independent model risk reviews and internal audit oversight of the modelled values that are used for risk management, compliance with the use test, input into pricing models, portfolio management and EC.

d. The EBA report should be refocused to report a comparison of the drivers of risk (the inputs into the Basel IRB formulas) instead of solely on the outputs from the formula (the OFR or RWA).

We support assessment on a less frequent basis than annually, but draw the EBA attention to inconsistencies with the Directive and the Basel 2 approach

4) We support the approach to the assessment of internal approaches on basis other than on an annual basis. However, we are concerned that assessment on a rotation basis every two years does not comply with the Directive that requires annual assessments. We recommend that the EBA seeks clarification on this matter.

5) We recognise the practical benefits of a rotation between low and high default portfolios – although the definition needs be consistent for everyone to be of use - in order to ease the burden upon institutions, the EBA and competent authorities. However.

    a) Nonetheless such an approach is based upon the premise that the OFR for each exposure, each portfolio and each asset class represents outputs that can be assessed on a standalone basis.

    b) Whilst this is true of the inputs and Expected Loss, it is not true of the Credit Risk OFR (RWAs). The reason is that the assessment of the OFR for Credit Risk must be looked at as a whole is in order to take into account the implicit correlation between portfolios that have variations through a cycle and the explicit obligor PD-dependent correlation parameters across asset classes embedded in the Basel 2 IRB formula and set out in the various explanatory notes published by the Basel Committee during the years 1999 – 2005.

    It is important to recognise that within an overall diversified portfolio of risk covering all four asset classes (Corporate, Mortgages, QRRE and Retail Other) there may well be compensating overestimations that are reflective of the differing points in the economic cycle.

    c) It is a fact that institutions have different risk profiles and different levels of concentration risk in each of the portfolios. Some institutions have corporate models that reflect exposures that are global. Others are regional and or EU country specific that may or may not include the same names. Some institutions are focussed on only one or two asset classes, such as the UK Building Societies that are country specific.

    It must be remembered that the output (OFR) i.e. the scaling up of EL into TL and then UL is based upon the Basel 2 assumptions i.e. a portfolio invariant approach correlated to single risk factor and devoid of any concentration risk.

    The EBA and competent authorities will need to bare these matters in mind when deliberating on the analysis of individual portfolios as well as overall portfolios of credit risk.

The need to include all internal approaches

6) We note that the RTS / ITS exclude QRRE and Retail Other and yet includes non-internal approach portfolios. We are concerned that a selective exclusion of and inclusion of these portfolios does not comply with the directive that requires the assessment of all internal approaches.

7) With respect to Counterparty Credit Risk it would seem that the focus is only the assessment of the IMM (Internal Model Methodology i.e. a focus only on the calculation of the EaD value) and the CVA models. Thus it would seem that there is no overall assessment of the OFR for counterparty credit risk to include the PD and LGD values. The standards applicable to the assessment of this risk should be consistent with Credit Risk.

8) Both the RTS and ITS focus only on Credit and Market Risk. They are deficient in that they do not provide details and guidance and templates specific to Equity, Securitisation and other IRB approaches.

RTS

There is a need to review the appropriateness of the benchmarks

9) The RTS is too granular and includes prescriptive approaches to determining statistical benchmarks for comparisons that should instead (if deemed appropriate) be set out in an ITS that are in future capable of review in the light of experience.

10) The focus only on the assessment of the outputs (RWAs) and the use of the same Gaussian normal distributions to determine outliers for all risks (1st and 4th quartiles) and to ignore 2nd and 3rd quartiles is difficult to justify.

    The consequence of the EBA approach will be place a burden of looking in detail at 50% of the institutions. Some members have suggested that the outliers should be assessed by reference to narrower bands such as top 10% or 5%. We note that afme and ISDA have proposed other statistical methods. Yet on the flipside we believe that the institutions, the EBA and competent all recognise that that there can be outliers within the 50% of 90% that are not looked at on the basis that there are compensating model risks and other risks that are obscure. The EBA will need to think carefully how to balance these factors and to determine how to provide guidance to competent authorities to look into further detail and thus to ensure that no outliers in fact exist within the samples that are not investigated.

11) The benchmarks of modelled inputs (PD, LGD, EaD [including CCFs) and maturity) and outputs (Expected Loss, Total Loss and Unexpected Loss) need to be specific for each risk type separately (Credit, Market, Equity, Securitisation and others), and that within Credit Risk benchmarks should be defined by asset classes and various subs-segments of these portfolios

Caution is needed when comparing the output from IRB vs Standardised Approaches

12) We understand that a rationale behind a comparison between the IRB outputs and the outputs from the Standardised Approach could be the follows:

    It enables a comparison between outputs derived from potentially differing modelling approaches with the output from a uniform approach.

    a. However, that does not mean that the Standardised Approach is a valid benchmark. It is quite possible that it contains underestimations and overestimations and thus includes significant model risk.

    b. Furthermore, it must be remembered that a comparison between IRB and Standardised Approaches is invalid due to conceptual differences in and the calibration of these portfolios and the different conceptual approaches (IRB (Unexpected Loss) vs Standardised (Total Loss), the treatment of defaults and EL deductions from the Core Tier 1 Equity.

    c. For example for each of the four asset classes the Basel 2 IRB formula results in a maximum Risk Weight percentage (e.g. for Corporate exposures the maximum 1 year RW % is 250% when the PD is 29% and LGD is 45%).[1] Thereafter the RW% declines such that the 1 year corporate IRB-Foundation RW% is 100% when the PD is 81.5% (i.e. the same as a PD of 2%) In practise what the formula is saying is that when the PD is 81.5% there is a requirement to deduct EL of $36 from CET1 and provide $8 in unexpected loss (RWA of 100). Thus in total c $44 is held in total capital i.e. de facto EaD x LGD.

    d. A possible solution to this conundrum in how to compare IRB with Standardised Approach for high PD would be to calculate an adjusted IRB Risk Weight % by adding back EL to derive a RW% based on TL%. This would result in an increasing RW% that would show the RW% for the Corporate PD of 81.5% equal to 552%. This would result in RWA of $552 and a minimum comparable capital requirement of $44 ($552 x 8%)[2]

    e. We note that the Directive does not contain any reference to or requirement for this comparison. If such a comparison is considered to have any value, it should be included in the relevant ITS, not in the RTS.

    f. Our preference is for the comparison to be removed from the RTS for the reasons as set out above

Care is needed when comparing outturns with modelled values

13) The conceptual approach to linking validation or lack of with only 1 and or 5 year outturns in order to form an opinion on the underestimation of the OFR is unsound without taking into account other data that the EBA has chosen not to request and or assess:

[1] RW% for institutions with total assets less than USD 100bn. For institutions with assets greater than USD 100bn the correlation scaling factor of 1.25 is applied and the maximum 1 year RW% rises to c 282%

[2] (This would though also require a corresponding adjustment to the calculation to add back the EL i.e. to increase the Core Tier 1 Equity)

a. The modelling approach, Point-in-Time vs Through The Cycle, time horizon of data, the idiosyncratic severity of the downturn period upon the institution etc are factor that must be considered

b. These factors and the point in the cycle results in outturns being rationally and logically higher or lower than the average downturn PD and LGD values. This is compensated by the deduction of EL from Core Tier 1 Equity that is ignored in the EBA assessment.

c. For low default portfolios, and or portfolios with low numbers of obligors in each rating, and or concentration risk in exposures and or segments (industry classifications, collateral coverage) etc. are all factors that can lead to differences between the EAD weighted PD compared with the actual defaults weighted by the number of obligors.

d. Validation of the modelled values PD, LGD and EaD primarily enables an assessment of the drivers of EL and thus an assessment of the comparison of the level of impairments with the value of EL that is deducted from Core Tier 1 Equity. It does not follow that conclusions can be drawn with respect to outliers in the calculation of OFR.

e. Many institutions use many more time series than the two periods of 1 and 5 years to validate the risk drivers. The EBA analysis will therefore not take into account the full set of data and period of back-testing conducted by institutions. On the contrary, some models have moved towards point in time to reflect the current and more recent and relevant risk profile. This may be particularly true where an institution has changed its business model and or underwriting standards to mitigate a repetition of the types of defaults and losses that occurred in the past. These factors do not seem to be catered for in the EBA assessment.

f. Given the requirement for an institution to model the risk drivers based upon its own experience of the downturn periods, it is a fact that the countries that will be the subject of the scope of the EBA assessment did not all experience the same level of downturn. The consequence is that institutions in countries, that experienced greater downturns during the recent crisis (such as Greece, Spain. Portugal, Ireland) should have relatively higher modelled risk drivers compared with institutions operating in lesser effected countries. The same holds true of individual asset classes and sub-portfolios that were not all equally impacted in every country. This is an example of different underlying drivers of the modelling of PD and LGD resulting in modelled values that are equally defensible that in turn would lead to differing and yet acceptable outputs. The EBA will need to take these factors into account in its assessment. However, from the proposed data to be collected, it is unclear how the EBA will achieve this.

The EBA should consider reviewing the scope of other data collected

14) Although the RTS provides guidance on the data that competent authorities should review and sets out a few data items to collate and thus to assess the validation of models, both the RTS and ITS are deficient because the templates set out in Annex V and VI are insufficient and incomplete. The EBA should take the opportunity to set out templates to require institutions to set out all the key drivers of each risk to facilitate the assessment required by competent authorities of the explanations of the outputs as required in Article 78 (1) second sentence.

ITS

A need to segregate ITS by risk type

15) The ITS is over-complicated and confusing because it combines Credit and Market Risk. The EBA should establish separate ITS for each type of risk and within Credit Risk separate ITS for relationship driven models that use the Corporate IRB formula distinct from Retail IRB portfolio approaches.

A need to review the templates to avoid duplication of submissions to the EBA - COREP

16) We recognise that the templates are designed to capture some data that is different to COREP. But nonetheless there is also duplication that should be avoided.

    The requirement for completion of credit risk templates in Annex I – IV has a number of shortcomings that will mean that a meaningful assessment or comparison cannot take place:

    a. These are duplicates of and inconsistencies with COREP.

    b. The completion of these templates places an undue burden upon institutions to submit another set of data that must be reconciled with existing EBA templates.

    c. Thus COREP should be used wherever possible and the ITS templates discarded.

    d. We encourage the EBA to conduct a comparison of the proposed templates with the COREP and eliminate duplications.

    e. We believe that there should be a clear differentiation between data collected that is actual and used data that reconciles to reported numbers in Pillar 3 and Annual Report & Accounts that is sourced from live systems as distinct to data that is theoretical and or hypothetical that is not retained in the same systems. The EBA templates do not make this differentiation sufficiently clear.

    f. The data elements setting out the approaches to calculate the reported values of PD and Maturity are invalid, because the reported values are not those that are used in the calculation of the OFR. Thus the calculation of OFR cannot be replicated from the submitted data.

    g. The aggregation of non-defaulted risk and defaulted risks results in totals that mask and distort the risk of the portfolios.

    h. The templates do not include the supervisory overrides (such as using the IRB-Foundation Approach) and or floors applied to institutions or analysis of different correlation parameters applied to corporate exposures for institutions below and above USD 100bn in assets, each of which has significant impacts upon the output.

    i. The templates allow institutions to submit data in accordance with their own rating scale. This does not and will not allow any comparative assessment.

Care is needed when comparing the modelled values for exposures

17) We are concerned that the collection of and comparison of the risk drivers (PD, LGD CCFs etc.) for exposures to similar obligors in different institutions may not provide any absolute or relative measures or risk for a number of reasons:

    a. It is not possible to draw absolute definitive conclusions from the outputs without an assessment of the comparison of the approaches to modelling the drivers of the risks i.e. the inputs into the IRB formula and geographical and or industry scope of each model.

    b. For each OFR for each obligor, facility, transaction or account the OFR (RWA) is only a marginal contribution to an assumed globally diversified portfolio that assumes portfolio invariance and an absence of any concentration risk.

    c. There is an explicit presumption that the IRB (and Standardised Risk Weight) formulas (developed over 12 years ago) that calculate the OFR i.e. the minimum capital requirement are still valid. There is a question mark over this assumption. [3] That is not to say that the outcome is necessarily not invalid. The global one-size-fits-all IRB formula (and for that matter the Standardised Risk Weights) may well still give a reasonable estimate of the total modelled losses of an institution.

    d. Institutions understand that both approaches (IRB and Standardised) contain model risk.

    e. We merely draw the EBA attention these matters and a need to exercise caution in standalone assessments of the OFR of obligors and or portfolios.

18) We are concerned that the collection of data that might be used in a hypothetical transaction for a hypothetical corporate within an institution's balance sheet leads to misleading conclusions and therefore has no basis for assessing the adequacy of the underestimation of the current risk profile for the reasons set out above.

19) It is quite possible that an institution's own risk appetite would not permit the hypothetical transaction and furthermore if the transaction were to be considered then immediate risk mitigation might be effected that is not captured by the EBA data.

20) Most IRB institutions now have dynamic portfolio economic capital based models that assess what institutions see as the true risk. Within the portfolio there might be specific names CDS hedges or portfolio CD hedges that substantially change the risk profile. It is unclear how risk mitigation such as CDS is accounted for in the EBA templates, data gathering and assessment.

[3] Those familiar with the formulas will be aware that outcome is derived by scaling up the marginal contribution of the expected loss (EL) of each obligor (or facility / transaction, pool or account) derived from a institution specific set of prior defaulted obligor – that are not in the current portfolio - based upon asset class specific PD dependent correlation values representing the single risk factor (i.e. the global economy as was in the 1990s) derived from the risk profiles of internationally active banks at that time - to calculate a conditional total loss (TL). The Asymptotic Single Risk Factor model assumes portfolio invariance and an absence of any need for granularity adjustment. The formula calculates TL to 90.90% level of confidence. Refer the "Explanatory Note on the Basel II IRB Risk Weight Functions" published in July 2005 for details. http://www.bis.org/bcbs/irbriskweight.pdf

21) A material risk within some corporate portfolios is maturity exposure beyond 5 years and or single name concentration (large exposures) that is not identified by the EBA. The EBA assessment will therefore not capture capital buffers that might be established by the institution and or competent authority.

22) The approach does not capture any macro-prudential capital buffer established by competent authorities such as systemic, sectorial and or countercyclical capital buffers.

Conclusion

23) We are concerned that an assessment that looks only at the OFR in isolation is deficient. We are concerned that competent authorities could conclude that action needs to be taken to impose additional capital requirements on institutions resulting from a review of a portfolio, and or disapprove the use of an internal approach because of the information provided to them by the EBA. This makes the task for each competent authority very challenging because they will not have access to the differences in the drivers of risk in another jurisdiction.

24) We believe that institutions that have over a decade of experience of modelling the credit risk drivers - that covers data gathered through the financial crisis - do understand the limitations, strengths and weaknesses of their models.

25) The EBA and competent authorities will be aware that institutions establish other internal buffers of capital to compensate for risks that might not be explicitly included in the modelled values. These factors that result in an institution’s board and the competent authority assessing the overall adequacy of Core Tier 1 Equity seem to be missing from the EBA assessment. We also note that assessment excludes the results of stress-testing exercises and or Asset Quality Reviews (AQR).

26) Also competent authorities and the ESRB have powers to add sectorial, systemic and countercyclical capital buffers to compensate for real and or perceived shortfalls in the calculation of the OFR.

    Other buffers such as G-SIFI and SIB buffers have been designed for similar reasons.

    We believe that these capital buffers that will be specific to each institution should be taken into account.

27) Therefore we believe that an assessment of the OFR should also take into account these other factors and buffers as well as composition of the calculation of the Core Equity Tier 1 and the assessment of EL vs Impairments and the ICAAP process.

28) In addition the RTS should provide cross-references to the Directive that set out the other obligations of competent authorities to assess the capital adequacy of an institution.

29) We have prepared an alternative draft of the RTS that would incorporate the comments set out in this response. We would be happy to share that draft and work with the EBA if the EBA wishes to do so.

Questions posed by the EBA

The EBA has requested responses to a specific set of questions. The following is a high-level response. Our concern is that the scope of the set of questions posed by the EBA is limited. That is why in order to comprehend the justification of our response, it is necessary to read the comments set out above

RTS

SECTION 2: Standards for the assessment to be done by competent authorities
Article 3: Overview
There are four questions

Q1. Do you consider the use of common benchmarks for credit and market portfolios necessary to ensure a common approach?

Answers: Credit Risk [4]

a) Common benchmarks may be appropriate where portfolios and risk management practices are similar. However, in practice there will be a number of factors which will result in variances between the results from different institutions, making meaningful comparisons quite challenging.

b) These will include (but not be limited to) differences in portfolio composition and size, risk appetite, risk profile, modelling approaches, local regulation, environmental factors and market composition. Therefore we would anticipate that there will be significant divergence in the results from different institutions which will limit the efficacy of the benchmarking exercise. The extent of the differences, and therefore the applicability of common benchmarks, will vary by portfolio, e.g.:

    i. For large corporates, publically available material and agency ratings provide a strong external view of the quality of the counterparty.

    ii. For mortgages, although there are significant differences relating to the factors mentioned above, some like for like comparison is possible through the comparison of only counterparties with similar major risk factors, i.e. segmenting the comparison by (for instance) country, current DTV and original DTI etc.

c) Applying common benchmarks for portfolios from different countries adds another level of reconciliation challenge related to differences in national regulation, legislation (e.g. legal terms of debt recovery and property law) and market composition. We question the extent to which the use of common benchmarks across countries provides meaningful information.

d) The EBA's own top down analysis of the consistency of risk weighted assets (RWA) suggested that 50% of the differences in the 'global charge' between banks mainly stem from the approach for computing RWAs in use (standardised vs IRB) as well as from the composition of each bank's loan portfolio (the 'A-type differences).

[4] Response is consistent with an institution specific response submitted by a BBA member

e) In other words, these are differences that relate to the structure of a bank's balance sheet as well as to its reliance on the different regulatory approaches for assessing and measuring risks. (The remaining 50% stem from the IRB risk parameters applied thus reflecting each bank's specific portfolio and risk management practices and risk modelling approach.)

f) As the EBA's report noted, the A-type differences can be easily explained and disentangled if proper disclosure is ensured and the EBA is already working to enhance disclosure in general, and in particular on RWAs.

g) It is not clear to what extent common benchmarks would bring further understanding of this.

h) We would also wish to avoid the use of benchmarks from becoming too restrictive and detracting from the institution's ability to undertake its own risk assessment based on strategy, risk appetite and market knowledge.

i) In summary using one set of benchmarks is inappropriate for dissimilar risks.

Answers: Market Risk [5]

a. For market risk, the use of common benchmarks is thought to be the most useful. However, two important considerations should be taken into account:
    a. When should benchmarks be used?
    b. How to turn benchmark data into conclusive assessments?

b. Benchmarking should take into account the internal back testing results, as this measure is an important metric to assess model performance.

c. Benchmarking is most useful if assessments and corrections (if required) are made about the value of all the drivers that have been used, such as the stressed VaR period.

d. By analysing the values of the risk measures, knowledge about the functioning of market risk models will increase.

e. If differences in these measures are present, it does not necessarily mean a bank's model is not functioning correctly; this should be the starting point for an investigation and dialogue.

f. If the differences are modest, say within a 20% range, additional investigations of banks in quartiles 1st and 4th will not add value.

g. Resources would be best allocated towards analysing significant outliers in these quartiles.

[5] This response is consistent with the response submitted by the EBF

Q2. Do you consider that the benchmarks outlined in the RTS are sufficiently proportionate and flexible?

Do you have any alternative benchmark proposals? If yes, please provide details.

Introductory comments

The choice of and definition of the first and fourth quartiles in the RTS to denote outliers are not supported by any statistical data. It is quite possible that different quartiles are required for each asset class (and sub-asset class) and regulatory approach (Corporate IRB-Foundation vs Advanced) and approach to calculating maturity. In fact it is quite possible that there will be institutions where the output modelling values and outcomes reported in the first and fourth quartiles are not outliers and that the outliers (i.e. under and over-estimation) lie within the second and third quartiles.

The proposed statistical measures are rudimentary and do not take into account established mathematical expressions to assess risks inherent in distributions such as mean, variance (and its positive square root, i.e. standard deviation), skewness, kurtosis and where deemed appropriate mixed moments and higher-order moments that can be used for description or estimation of further shape parameters.

The equally plausible conclusion is that similar and or dissimilar modelling values that result in similar outputs (that fall within 2nd and 3rd quartiles) could also be wrong is ignored from a statistical perspective.

Thus the EBA does not give credence to the plausible conclusion that similar and or dissimilar modelling values for the same exposure (or risk profile in aggregate) could be within the boundaries of modelling acceptability. Thus the varying output of all values in different institutions is an indicator that very little may be wrong.

The reality is that there are a range of internal approaches in institutions to modelling similar risk profiles. It is probable that some of these approaches are deficient. What is certain is that every model, the internal approaches of institutions to derive the inputs (drivers of risk), the Basel formulas – that are models (IRB and The Standardised Approaches), and thus the outputs contain model risk.

This is an important matter, because the point about the IRB approach is as follows:

- **Similar r**isks in different institutions can lead to **dissimilar** calculations (outputs) of the marginal contribution of expected, total and unexpected losses of each obligor, facility, pool, account or transaction.

- **Dissimilar** risks in different institutions can lead to **similar** calculations (outputs) of the marginal contribution of expected, total and unexpected losses of each obligor, facility, pool, account or transaction.

At the heart of this matter is the fact is the discussion as whether or not it is possible to compare the modelling values or outputs of the same exposure modelled by different institutions.

This response will explain why and set out the reasons why is necessary to take care when reviewing the outcomes of data submitted by institutions in compliance with the RTS and ITS

Answers

a) No we do not consider the benchmarks to be sufficiently proportionate and or flexible.

b) The mechanistic simplistic approach is not based upon any evidence of or back-testing to validate the EBA presumptions.

c) We believe that benchmarks need to be specific for each risk type separately (Credit, Market, Equity, Securitisation and others), and that within Credit Risk benchmarks should be defined by asset classes and various subs-segments of these portfolios

d) The RTS should be refocused to an assessment and the definition of a benchmark by assessing and benchmarking the quality of the modelling of the inputs, i.e. the drivers of risk.

e) But this in turn is not a simplistic comparison of the values assigned by different institutions (PD, LGD, Credit Conversion factors) to derive any indication of outliers. It is the assessment of and the comprehension of the underlying models that are the cause of the differences.

f) The EBA draft RTS and ITS will not enable these fundamental comparisons to be carried out

g) We believe that progress to collate data in a systematic manner with respect the modelling choices to determine the drivers of risk are areas that the EBA should focus its attention

h) We believe that improvements to public disclosures with respect to back-testing would also help and we urge further coordination with the Enhanced Disclosure Task-Force (EDTF) and Basel Committee with respect the proposed templates for Pillar 3 reporting.

i) We believe that the EBA should avail itself of the work that has already been undertaken and published by competent authorities that have set out the expectations, guidance and policy with respect to the modelling of values used in the internal approach. For example we cite:
   a. Supervisory Statement SS1/13: Credit risk: internal ratings based approaches published in August 2013 by the Bank of England / Prudential Regulatory Authority [6]

j) For market risk, benchmarking should only be done for portfolios where the bank actually trades in, or has trades existing. For some portfolios, one could consider to assess maximum loss figures (e.g. for long options one can in principle not lose more than the premium).[7]

[6] http://www.bankofengland.co.uk/pra/Documents/publications/ss/2013/ss113.pdf
[7] This response is consistent with the response submitted by the EBF

Q3. What limitations do you see in relation to the use of the proposed benchmarks, i.e. a) first and the fourth quartiles; b) comparison between own funds under the internal models and the standardised approach; and c) comparison between estimates and outturns?

Answers

Quartiles

a) The EBA assumes that the 50% of the values lying within the 2nd and 3rd quartiles do not contain any outliers and that only those in the 1st and 4th quartiles do.

b) These assumptions are without any statistical basis and thus are conceptually unsound to be relied upon for compliance with the Directive.

c) There is the probability that values in the 1st and 4th quartiles are not outliers, but in fact represent conservative values for those institutions taking into account their idiosyncratic historical defaults and or loss profile

d) Establishing simplistic statistical measures based upon the concept of normal Gaussian distributions around a mean for all risks is conceptually unsound.

e) Therefore the use of quartiles to provide a preliminary identification of significant differences may in fact exacerbate legitimate differences in outcomes between institutions that do not represent different underlying risks. For example,

    1) Pressure may be placed upon a bank to increase its fourth quartile RWA outcomes for a portfolio notwithstanding its stringent underwriting practices;

    2) Another bank operating in the same market but with high risk appetite may successfully underestimate its RWA requirements provided that its estimates lie within the second or third quartile of outcomes

IRB vs Standardised Approaches

a) There is presumption that the Standardised Approach results in outputs that can form the basis of a comparison and thus ergo deviations of IRB outputs from the Standardised Approach are a sound basis from which to assess outliers derived from the IRB approach.

b) The comparison is conceptually unsound for a number of reasons.

c) Credit Risk IRB is an unexpected loss methodology in which the expected loss is deducted from a total loss. It embraces the concept that there is a tipping point in which one year EL is greater than UL thus resulting in the Risk Weighted Asset falling back to zero. It includes maturity scaling adjustments and SME adjustments as well

d) Whereas the Credit Risk Standardised Approach is a Total Loss model and does not contain any assessment of Expected Loss and or maturity transformation.

e) There are conceptual differences between the two approaches with respect to defaulted exposures and impacts upon the Core Tier 1 Equity (i.e. the numerator in the capital ratio) and denominator (i.e. the modelled losses i.e. the Risk Weighted Assets).

f) Thus there is just as much likelihood that for an institution that the model risk lies in the Standardised Approach and that the calculation of the OFR using that approach is an underestimation or overestimation.

g) For market risk, the benchmark should not be based on the standardised model, which is being reviewed anyway. We recommend the EBA to perform the benchmark based on the values of risk factors instead. We note that the EBA proposes that portfolios with specific relevance for EU non-Euro banks should be included in the market risk benchmarking. That is of course of interest, however it should be noted that there are only four banks in Denmark and Sweden altogether with IMAs and currently only one with specific risk approval. Therefore the outcome of the benchmarking will be very limited. [8]

h) As regards the confidence level set at 97.5%, it could prove inappropriate on some portfolios (owing to various sample sizes, or to the weight of expert judgment in the rating process). We wonder whether there is evidence grounded on economic or academic studies establishing the relevance of such a confidence level. [9]

Comparison between estimates and outturn

a) The conceptual approach to linking validation or lack of with only 1 and or 5 year outturns in order to form an opinion on the underestimation of the OFR is conceptually false without taking into account other data that the EBA has chosen not to request and or assess:

b) The modelling approach, Point-in-Time vs Through The Cycle, time horizon of data, the idiosyncratic severity of the downturn period upon the institution etc. These factors and the point in the cycle results in outturns being higher or lower than the average downturn PD and LGD values.

c) For low default portfolios, and or portfolios with low numbers of obligors in each rating, and or concentration risk in exposures and or segments (industry classifications, collateral coverage) etc. are all factors that can lead to differences between the EAD weighted PD compared with the actual defaults weighted by the number of obligors.

d) Validation of the modelled values PD, LGD and EaD primarily enables an assessment of the drivers of EL and thus an assessment of the comparison of the level of impairments with the value of EL that is deducted from Core Tier 1 Equity. It does not follow that conclusions can be drawn with respect to outliers in the calculation of OFR.

e) Many institutions use many more time series than the two periods of 1 and 5 years to validate the risk drivers that will be omitted in the EBA assessment.

[8] This response is consistent with the response submitted by the EBF
[9] This response is consistent with the response submitted by the EBF

Q4. What in your view is the most appropriate benchmark and/or approach for the assessment of the level of potential underestimation of own funds requirements?

Answer

a) The most appropriate set of benchmark is to establish an assessment process that also looks at the internal validation of the modelled values, i.e. the drivers of risk determined by each institution on a standalone basis.

b) We recommend the templates set out in ITS Annex V and VI are substantially revised and extended to capture the data set out in RTS Article 8. Refer to the answers to question 13 further below.

c) If each institution's own models are validated and reviewed by an independent model risk review function and processes found to be satisfactory by internal audit (including the correct input in the Basel formulas), then do not these assessments in their own right validate the output?

d) The logic of this argument is that if a Competent Authority considers the output from the IRB Credit Risk to be inappropriate, then is not an equally valid conclusion that there might other things that might also be the cause of concern? For example:

   a. The calibration of the IRB Formulas such as PD-dependent correlation parameter (and the 1.25 scaling factor for institutions with assets more than USD 100bn), SME adjustment, the scaling to 99.90% level of confidence and the maturity scaling factor. All these values were defined by the Basel Committee.

   b. Supervisory adjustments (floors, overrides etc.)

   c. Other macro-prudential and micro-prudential capital buffers (Systemic, Counter-cyclical, sectorial) that might not represent the idiosyncratic risk of that institution and yet add a level of conservatism to the institution's OFR that might eliminate any perceptions with regard to underestimation.

   d. Inappropriate and or absence add-on buffers to cover concentration risk (granularity adjustment).

   e. Institution specific buffers including G-SIFI and O-SIFI and others resulting from the ICCAP.

e) For **market risk,** the most appropriate tests are the internal back testing results. Benchmarking can add a lot of value in this domain, provided the differences in risk factors are well understood. [10]

[10] This response is consistent with the response submitted by the EBF

ITS

Q5. Which set of market risk portfolios do you consider more appropriate for the initial exercise conducted under Article 78?

Answers [11]

a) We would favour the second option, namely the use of the same portfolios as in the hypothetical portfolio exercises of the Basel Committee and the EBA.

b) Based on the experience of our members, using existing high quality portfolios will produce better results and reduce the development effort required.

c) However, for banks which do not already participate in the exercise of the Basel Committee the second option could be unduly burdensome as it would entail portfolio set up costs in order first to apply the Basel portfolio for the 2014 exercise and later new portfolio set up costs in order to apply an EBA portfolio for 2015 onwards.

d) We therefore urge the EBA to consider the possibility of exempting banks which do not already participate in the exercise of the Basel Committee from the 2014 exercise or, alternatively, to develop the EBA portfolio to be used from the outset, while allowing banks already participating in the Basel exercise the option to use the Basel portfolio for the 2014 exercise.

[11] This response is consistent with the response submitted by the EBF

Q6. As explained in the background section, do you consider the approach proposed by the EBA appropriate for future annual exercises?

Answers

Choice of portfolios

a) We are concerned that the ITS does not comply with the directive Article 78 (5) that mandates that "*competent authorities shall ensure that their decisions on the appropriateness of corrective actions as referred to in paragraph 4 comply with the principle that such actions must maintain the objectives of an internal approach."*

   The reason is that the EBA starts from the premise that competent authorities are only required to look at portfolios that are outliers as defined by the EBA. This is set out in Recital (6) of the RTS *(6) As the second subparagraph of Article 78(3) of Directive 2013/36/EU refers to the EBA report as a means for assisting competent authorities in their assessment according to the first subparagraph of that Article, such a report is a cornerstone of the benchmarking exercise as described in that Article, given that such report shall contain the results of the comparison of relevant institutions with their peers at the EU level, and given that only the EBA shall avail of all relevant data for all relevant institutions in the Union. Hence the information contained in the EBA report should constitute the benchmark based on which to decide which firms and portfolios to assess with 'particular attention' as required by the first subparagraph of Article 78(3) of Directive 2013/36/EU*.

   We believe that this is limiting and can result in an unfair focus on only a subset of the entire risk profile.

b) We note that the Directive requires an annual assessment of all portfolios subjected to the internal model approaches. *At least annually, competent authorities shall make an assessment of the quality of those approach*

c) The ITS Allows portfolios to be assessed every two years:
   a. Includes some portfolios that are not subjected to the internal approach
   b. Excludes some Retail portfolios i.e. QRRE and Retail Other that should be included in the assessment.

d) We support the EBA in its desire to deviate from the directive. However, we question whether the EBA can do this without the approval of the Council and thus an amendment to the Directive

Allowing sufficient time to implement

e) Fundamentally, there is a need for sufficient time for multiple iterations during the validation stage, to perform a pilot with a limited number of firms and to provide comprehensive manuals and FAQ through the EBA's web-site and multiple channels.

e) Therefore, we believe that there are risks in implementing an EU–wide approach all at the same time.

f) We would recommend that for the first time for each of the risks that the EBA may wish to confine itself to institutions that have consolidated assets in excess of EUR 500 billion in order to have a test-run of the process. This approach has been adopted for example for stress-testing before a wider roll-out.

g) Such an approach would be more manageable for the EBA and competent authorities and would allow for a review of the data gathering exercises, processes, assessments and revisions to the ITS before a roll-out to all IRB institutions

h) We wish to draw to the attention of the EBA that the calibration of Basel 2 IRB approach was based upon the concept that the capital requirements for Credit Risk should be assessed in aggregation across Corporate, Retail (Mortgages, QRRE and Other) on an annual basis.

Care is needed when assessing the HPE [12]

i) As to the design of the benchmark portfolio, the use of non-existing transactions is unrealistic and should therefore be reconsidered.

j) Banks should use transaction types present in their portfolios otherwise the meaningfulness of the benchmark exercise is questionable.

k) Risk assessment is not a mere calculation engine but it is a wider discipline involving qualitative assessment, internal controls, governance and other features; the quantitative element is just one more part of risk management.

l) It is important to analyse and understand the root causes of the differences.

m) We would like to focus our comments on the use of HPE for LDP: this approach seems very hard to use, especially as far as secured LGD is concerned, mainly for these reasons:

    i. In contrast to previous HPE which used existing transactions, this one proposes underlying transactions that do not exist in the bank's portfolio. This would put into question the reliability of estimates and would materially increase the workload.

    ii. It is highly unlikely that banks can provide all the requested information to determine CCF/LGD Secured. LGD secured is not function of the collateral itself but it also depends on other factors including:
        i. the type of collateral, location, and condition;
        ii. its accessibility (e.g. seniority of the claim, legal environment, nature of the counterparty);
        iii. the characteristics of the loan (e.g. type, LTV);
        iv. the purpose of the asset.

    iii. The outputs would depend on the zone of expertise of some institutions: for instance, a bank would be able to give an LGD estimate for a real estate transaction in its country, whereas it would probably be much more difficult for a foreign retail bank.

n) In conclusion the value of the approach is felt as limited, mainly owing to representativeness issues. We also would like to draw attention to the fact that combining this approach with others for benchmarking purposes would become really burdensome for banks with LDP.

[12] Comments submitted by the EBF

Q7. Do you have any alternative proposals? If yes, please provide details.

Answers – Credit Risk

a) Yes

b) We believe that in line with the response to Q4, that the EBA should change its focus from looking at the outputs to assessing the adequacy of the modelled values – drivers of risk – that are institution specific in order to derive meaningful comparisons of the differences in the risk drivers.

c) We take the opportunity here to comment that any alternative benchmarks should always respect the following principles: [13]

   I. The first step of any benchmarking exercise should be to establish what the key drivers behind RWA divergences are

   II. Benchmarks should be expressed in terms of ranges of acceptable divergences rather than single, simplistic values

   III. Benchmarking frameworks should be refined by segmentation according to the relevant key drivers of divergences such as, but not limited to, bank type, asset classes, geographical sector, etc.

Answers – Market Risk [14]

a) The suggested approach appears to be logical and having an assessment of the quality of market risk models is supported.

b) As the Basel Committee has already concluded that the current market risk framework should be revised, the information gathered from benchmarking exercises such as this one would be beneficial for the quality of the fundamental review of the trading book.

c) In any case, closer coordination on timing and content of HPE requirements and exercises would be useful. Also, submission of results should not take place until firms have come to a consensus on position specification.

[13] Response is consistent with the response submitted by afme and ISDA
[14] Comments submitted by the EBF

Q8. Which of the two options for phasing-in do you consider preferable?

Answers:

a) Stable portfolio definitions are essential to implement standardised reporting and to reduce operational risk. Therefore a phasing-in over time would allow learning to be taken into account.

b) Therefore, we support phasing-in over time (with reasonable lead time) rather than hoping to successfully define portfolios once and once only in the 2015 exercise.

c) As set out in the response to Q6 we recognise that for pragmatic reasons that the EBA considers it appropriate to segregate LDP from HDP portfolios on a rotation basis. Nonetheless, we have drawn to the EBA notice that assessment of portfolios on a standalone basis is inconsistent with:

   I. The principles set out in the Basel 2 framework and its explanatory notes published between 1999 and 2005.
   II. The directive that requires all IRB approaches to be assessed on an annual basis
   III. The exclusion of the QRRE and Retail Other portfolios

d) If the EBA considers that assessments should be carried out at intervals of more than a year and on a rotation basis, as well as excluding some IRB portfolios we recommend that the Directive is amended.

e) We believe that consideration should be given to the Directive being amended to exclude the assessment being carried out for all exposures to Central Banks, Central Governments and Institutions on the basis that it is very difficult to validate the OFR derived from the internal models. [15]

Choices of the options as presented [16]

f) The phase-in option (number 2) is preferable on the grounds that it is:
   a. The less costly;
   b. The one with the longest lead-in time.
   c. For market risk, the actual portfolios should be used. If it is decided to use new ones instead, there should be good test procedures in order to ensure high portfolio quality.

Alternative options based upon an approach that has a test run with only significant institutions:

g) A phasing with rotation by risk
   a. in 2015 – Market Risk
   b. in 2016 – All Credit Risk (including counterparty credit risk) for institutions with consolidated assets in excess of USD 500 billion
   c. in 2017 – Other risks
   d. in 2017 – Market Risk
   e. in 2018 – Credit Risk for all IRB institutions in the light of the 2016 exercise

[15] We note that the Bank of England has recently published its guidance on the requirement to use IRB Foundation approach for these exposures on the basis that it deems there are insufficient defaults
[16] Response provide by the EBF

Q9. Do you see any potential ambiguities in the credit risk portfolios defined in Annex I? Please identify the relevant portfolio providing details and any suggestions that would eliminate these ambiguities.

Answers

a) Yes we see ambiguities and thus we have concerns with respect to the draft ITS.

b) It is our reading of the Directive that the assessment relates to portfolios of risk where the OFR is calculated based upon the internal approaches i.e. with respect to Credit Risk the IRB approaches.

c) Therefore we believe that all reporting to the EBA should be consistent with this directive and all reporting of actual data should be consistent with COREP

d) It is for that reason we believe that the templates set out in Annexes I – IV should be withdrawn and instead the templates defined in COREP used as the basis for assessment.

e) Only where data is required that is supplementary to the existing COREP templates should it be requested in the ITS.

f) It is costly and inefficient for institutions to have submit data twice and then perform reconciliations.

g) We draw the EBA attention to the Directive Article; 78 (1), second sentence requires *that institutions shall submit the results of their calculations, together with an explanation of the methodologies used to produce them, to the competent authorities at an appropriate frequency, and at least annually*.

h) The EBA has decided only to provide in the RTS guidance on the documentation and data that it would expect a competent authority to review.

i) The EBA has therefore missed an opportunity to set out templates to gather this information in a consistent manner for each risk and asset class.

j) It is our view that the collation and assessment of the internal approaches to modelling the drivers of risk is the fundamental starting point that underpins the Basel Accord.

k) So, yes, we see many ambiguities with respect to Annexes V and VI.

l) It is inappropriate to establish templates to cover all credit risk asset classes.

m) The templates are incomplete and add little to the capability of either the EBA and or competent authorities to determine whether there is any under-estimation of the OFR for the reasons set out elsewhere in the summary to this response and in responses to specific questions.

Concerns with respect to the definition of default and comparison of retail portfolios [17]

n) As permitted under CRR Article 178, default may be defined as occurring when residential property exposures are 90 or 180 days past due. This may drive variances across the Defaulted Mortgages portfolios.

o) We would note that benchmarking will not be able to generate a like for like comparison without understanding the geographical area the model is contained within, the different portfolio make up that the model is trained upon and the rating model philosophy applied (Through the Cycle vs Point in Time) for example.

p) We consider it more appropriate to report Retail Non SME Mortgages by geographical location of the property (rather than by the geographical location of the counterparty) where the property is the main component of collateral. It is considered more appropriate to use the location of the property to drive residential mortgage reporting as the risk is largely driven by the economic environment, property market and litigation legislation and practice within that country.

Counterparty credit risk [18]

q) We note that the EBA proposes to align with the Basel SIG TB exercise for the benchmarking of counterparty credit risk in 2014 to cover IMM and CVA models.

r) We are concerned that the EBA paper contains little information on the proposed counterparty risk portfolios for 2014 or on what portfolios would be used from 2015.

s) The EBA paper refers to the scarcity of resources and the existing workload both for banks and NCAs. We would agree with EBA's concern about resources and would propose that the 2014 exercise cover only the IMM component of counterparty risk and not CVA.

t) Further, we would recommend that only one asset class be covered in the first year. Benchmarking interest rate products, for example, would cover a significant amount of the exposure and would allow for a meaningful comparison to be made between firms. This would be analogous to the phased approach for credit risk supported by AFME (i.e. where EBA propose to perform the analysis of High Default Portfolios (HDP) and Low Default Portfolios (LDP) in alternate year).

u) We note that the counterparty risk sections in Annexes VIII and IX are incomplete.

v) When the EBA is able to publish details on the counterparty risk benchmarking proposals, we would recommend that the EBA considers defining consistent margin terms and collateralisation agreements. This will help ensure that own funds and RWA divergences are correctly attributed to real differences in firms' modelling and risk management practices and not differences that arise from margining assumptions used when the hypothetical portfolios are booked into systems.

[17] Response is consistent with an institution specific response submitted by a BBA member
[18] Comments made by afme and ISDA

The template(s) (para 8)

For reporting the own funds requirements for the benchmark portfolios - as required in paragraph (1) - which contain any value determined by an institution relating to exposures to obligors

The list of benchmark portfolios (referred to as Exposure Class) and the data requirements are set out in Annex IV templates C102 and C103.

a) Central banks and central governments (excluding LCY exposures funded by LCY
b) Institutions
c) Corporate – SME
d) Corporate – Specialised lending
e) Corporate – Other
f) Retail – Secured by real estate SME
g) Retail – Secured by real estate non-SME
h) Retail – Qualifying revolving
i) Retail – Other SME
j) Retail – Other non – SME

It is noted that only exposures to Central Banks & Central Governments and Institutions have been exclusively been identified as Low Default Portfolios (LDP). All the other asset classes have been listed as both LDP and High Default Portfolios.

For each template and for each exposure class there is a requirement to identify and differentiate the regulatory approach as follows:

a) Foundation IRB Approach.
b) Advanced IRB Approach
c) Slotting criteria
d) Equity - PD/LGD approach
e) Equity - Simple risk-weight approach
f) Equity - Internal models approach
g) Securitisations - Ratings based method
h) Securitisations - Supervisory formula method
i) Securitisations - Internal assessment approach
j) Not applicable

The data reporting requirements for LDP and HDP are identical. On the basis that there is no definition of LDP vs HDP, the differentiation to report an exposure in C102 as distinct to C103, the templates should be eliminated and one template required.

The primary differences are that COREP-FINREP

1. Requires separate templates for IRB Foundation and IRB Advanced approaches for non-Retail exposures.
2. Segments SME between those portfolios subject to and not subject to the SME supporting factor.

We consider that the EBA should review its segmentation and reporting to be aligned with COREP in order to facilitate ease of reconciliation within institutions.

For the portfolios that have been included, the list of asset classes, regulatory approaches and segmentation of those portfolios are inconsistent with the requirements set out by the EBA in COREP.

The EBA has chosen to categorise credit risk portfolios as low or high default portfolios (LDP v HDP) when it in fact it is noted that the data reporting requirements are identical (Annex IV C102 and C103. The categorisation would seem unnecessary and confusing.

One template has been specified to cover different credit risk asset classes. This is inconsistent with Section 3.3.1 of COREP that sets out the scope of the Credit Risk IRB template:

Paragraphs 75 and 76 of that RTS state that *the scope of the CR IRB template covers own funds requirements for Credit risk in the banking book, among which:*

- *a) Counterparty credit risk in the banking book*
- *b) Dilution risk for purchased receivables*
- *c) Counterparty credit risk in the trading book*
- *d) Free deliveries resulting from all business activities.*

Para 76.

The scope of the template refers to the exposures for which the risk weighted exposure amounts are calculated according to Articles 151 to 157 Part Three Title II Chapter 3 CRR (IRB approach).

Para 77.

The CR IRB template does not cover the following data:

- *i. Equity exposures, which are reported in the CR EQU IRB template;*
- *ii. Securitisation positions, which are reported in the CR SEC SA, CR SEC IRB and/or CR SEC Details templates*
- *iii. "Other non-obligation assets", according to Article 147 (2) point (g) CRR. The risk weight for this exposure class has to be set at 100 % at any time except for cash in hand, equivalent cash items and exposures that are residual values of leased assets, according to Article 156 CRR. The risk weighted exposure amounts for this exposure class are reported directly in the CA-Template*
- *iv. Credit valuation adjustment risk, which is reported on the CVA Risk template;*

The CR IRB template does not require a geographical breakdown of IRB exposures by residence of the counterparty. This breakdown is reported in the template CR GB.

The RTS therefore sets out templates that are different to and inconsistent with the templates set out in COREP. A high-level review of the data requirements set out in the RTS has been compared with COREP-FINREP. This review has identified different formats and different data items.

Given the significant time and effort that has been expended by the EBA, competent authorities and institutions to finalise and establish IT infrastructure in order to comply with the reporting for COREP and FINREP, it is inappropriate, and not cost-justified to require institutions to submit data that substantially duplicates these processes. Furthermore, we have noticed that a comparison of the two templates (Benchmarking vs COREP-FINREP) contain inconsistences in the data elements requirements.

We conclude that the cost-benefit analysis / impact assessment as set out in section 5 may be deficient.

Specific comment on templates

a) The principal shortcomings are:

I. Institutions are permitted to report the data in their own rating system of up to 30 grades (master scale). This invalidates all comparisons.

II. The methodology set out by the EBA to report PD and maturity for each rating derived by weighting EaD is incorrect. These values are not the values that are used in the calculation of the OFR. Thus the OFR cannot be independently replicated.

III. The reporting templates exclude data such as supervisory floors and overrides and correlation scaling factors, (1.25x) and data used for the SME adjustment

IV. The templates do not set out how to calculate totals for each portfolio.

V. The templates do not segregate the risk of non-defaulted from defaulted exposures. Adding these two portfolios together makes overall comparisons very difficult.

b) The assumption is that the drivers of risk for actual exposures to the same obligor and or hypothetical transactions can be compared across institutions are untrue unless the reasons for the drivers of risk i.e. the modelling choices are assessed and compared.

c) Annex 1

   a. C101: Col 450: Clarification is required with respect to residency. It would make sense for this to be consistent with the definition as set out in the EBA RTS and ITS with respect to the calculation of and the reporting of the countercyclical capital buffer based upon the obligor.

   b. C103: Col 160: The template asks for maturity for a retail exposure, especially mortgages. Although this value is not used in the calculation of the OFR, nonetheless it might be useful to provide an assessment with regard to repayment profile. It is noted that some banks report the expected repayment profile of retail exposures in Pillar 3.

Q10. Do you have any suggestions for additional credit risk portfolios? Please provide details.

Answers.

a) It is an irreconcilable challenge to compare exposures to Large Corporates, because of the low default nature, the different geographical distributions, and industry classifications spread of the modelled portfolios and the application of the models to current non-defaulted exposures that have different concentrations to industries and geographies and may or may not represent the risk profile of the portfolio that was in place during the financial crisis and or modelled.

b) That is why there is a need for detailed work by model validation teams, independent model risk review functions and competent authorities to comprehend the nuances of each portfolio. We are concerned that the data that the EBA is gathering falls short of that required in order to perform the assessment set out in the directive

c) The IRB portfolios for exposures to Central Banks, Central Governments and Institutions should be excluded (by obtaining an exemption to the directive) on the basis that it is very difficult to validate these internal models and that furthermore it would seem that some competent authorities have already taken action to mandate the use of the IRB-Foundation Based approach which can result in differences with institutions that have been permitted to use the IRB Advanced approach.

d) The fact that exposures to EU Central Banks and Central Governments in local currency are excluded whereas exposures to non EU G20 countries are included (i.e. USA, Canada, Australia, Brazil, Japan, etc.) leads to incomparable distortions in the assessment of the estimation of OFR for this asset class.

e) We believe that a consequence of Basel 3 and the BRRD (EU Banking Recovery and Resolution Directive) is that the concept of a default of an EU institution has changed from the original intention of Basel 2. The EBA might therefore wish to consider how in light of these changes the OFR for exposures to institutions should be assessed.

f) All other IRB portfolios – i.e. QRRE and Retail Other should be included.

Q11. Do you see any potential ambiguities in the market risk portfolios defined in Annexes VII.a and VII.b? Please identify the relevant portfolio providing details and any suggestions that would eliminate these.

Answer [19]

a) Market risk proposals indicate that banks should calculate risk figures in the currency of the particular portfolio specified in order for the result not to be polluted by currency effects.

b) However, models of non-Euro markets (e.g. the UK, Denmark or Sweden) are in some cases set up to calculate with an outset in non-Euro therefore the conversion is a time-consuming complication. In our view, it should not be generally expected that banks be able to do this.

c) General comments regarding benchmark portfolios:

d) Portfolios should to be available well in advance of the exercises. They should be extensively tested by the competent authority to avoid any confusion or late changes to the portfolios. If possible, a rough indication of the MtM should be available at the moment of the publication of the portfolios.

e) The competent authorities should structure the portfolios in such a way that the specific model item can be properly tested. For instance, if the purpose is to test VaR models for interest rate volatility, the portfolio should be structured in such a way that all non-vega sensitivities of the portfolio are small. In this specific case for example the portfolio with a swaption can be made delta neutral by adding an interest rate swap.

f) As regards ambiguities, the definition of portfolios in terms of how to combine the various positions (section 3, Annex Vii.a) should be clarified. For example, portfolio II is described as 1-50 instruments, 2-9 instruments and 3-1 instrument. We understood 1-50 instruments to mean long all positions labelled as 1-50 in section 2.

Please refer to the EBF and afme and ISDAs responses for additional information

[19] This is the EBF response..

Q12. Do you have any suggestions for additional market risk portfolios? Please provide details.

We support the following responses:

Response submitted by EBF

As the risks for most banks are plain vanilla, the EBF suggests replacing exotic portfolios by vanilla portfolios.

While we reiterate our preference to use the Basel portfolios as outlined in the response to Q5. However, in case option two would also be used, we would propose introduction of an FX vanilla option out of the money with strike far from the FX forward by 2.33 standard-deviations for FX test portfolios. The goal being to check if the VaR captures the convexity between the current FX Spot and the 99% FX Spot bump. For illustration, the related instrument could be:

Sell call EUR put USD with strike = Current FX Fwd x (1 + 1%) and sell put EUR call USD with strike = Current FX Fwd x (1 - 1%).

Response submitted by afme and ISDA

For FX test portfolios, we propose to introduce a FX vanilla option out of the money with a strike far from the FX forward by 2.33 standard-deviations. The goal is to check if the VaR captures the convexity between the current FX Spot and the 99% FX Spot bump: does the methodology use a Taylor approach or a full Revaluation? For the sake of illustration, the related strategy could be:

Sell call EUR put USD with strike = Current FX Fwd x (1 + 1%) and sell put EUR call USD with strike = Current FX Fwd x (1 - 1%)

Q13. Do you agree with the possibility of allowing firms to refrain from reporting portfolios if one of the conditions stated in Article 3 is met?

We support the following responses:

Response submitted by afme and ISDA

a) We indeed think some exemptions should be granted, especially when they contribute to a better understanding of the results overall (in practice, adding minor portfolios at the expense of the overall precision of the results would be undesirable).

b) We suggest the following process: banks select the portfolios which they think would be legitimate to exclude, based on a series of objective factors. These would be defined by the Competent Authority and include quantitative factors as well as qualitative factors (e.g. portfolios in run-off).

c) A discussion would then take place between the supervisor and the bank to reach a conclusion on whether it is appropriate to exclude such portfolios, or maintain them in the analysis.

d) Nevertheless, we do recognize that exemptions could lead to comparability issues for all-in portfolios.

Q14. Do you have any suggestion about additional exemptions from reporting? If yes, please provide details.

Answers

a) As set out in the response to previous questions, we believe that here should not be any exemptions other than those permitted by the Directive.

b) If the EBA should wish to extend the number of portfolios exempted from an assessment, it should do so by asking for an amendment to the directive, and or setting out the relevant articles that permit competent authorities the authority to apply national discretion.

We support the following responses:

Response submitted by EBF

a) It should be noted that individual clusters as defined may be immaterial for certain banks. In such cases, banks should also be afforded exemptions from reporting where to do so is overly burdensome.

b) Another case that could grant an exemption is when an institution is in the process of purchasing another financial institution until decisions are made and authorised regarding the merger of portfolios.

c) It would be welcomed to envisage also an exemption for credit risk.

d) Portfolios with partial roll-out should also be exempted (or alternatively, the share of the portfolio under Standard approach should be highlighted and the bias resulting from different capital treatments should be eliminated).

e) Local entities supervised by a host supervisor should also be exempted from solo reporting as long as their portfolios are included in the consolidated vision submitted to the home supervisor.

Market risk

f) The exemptions should be based on situations where the institutions are under a model validation process for the portfolios included in the samples or for non-material portfolios. As such, a materiality threshold could be defined as:
   a. An absolute portfolio size;
   b. A relative portfolio size, in comparison to the total consolidated balance-sheet or to the balance-sheet size of the subsidiary.

Appendices to support the comments and answers

The Directive Article 78

We have reviewed the directive and note that it sets out five separate exercises that are required to be performed and assigns responsibility to each of these:

1) **Reporting** - This is the responsibility of the institution.
    i. The outcomes of IRB portfolios to competent authorities and the EBA in accordance with templates developed by the EBA.
    ii. An explanation of the methodologies used to produce them, to the competent authorities at an appropriate frequency, and at least annually

2) **Monitoring** the outcome (the RWAs). This is *the range of risk weighted exposure amounts or own funds requirements for the exposures or transactions in the benchmark portfolio resulting from internal approaches of those institutions.* This is the responsibility of the competent authority.

3) **Assessment** of the internal approaches that are used determine derive the outcome This is the responsibility of the competent authority.

   The Directive states that *at least annually,* c*ompetent authorities shall make an assessment of the quality of those approaches paying particular attention to:*

   a) those approaches that exhibit significant differences in own fund requirements for the same exposure.
   b) approaches where there is particularly high or low diversity (of approaches)*, and also where there is a significant and systematic under - estimation of own funds requirements.*

   With respect to Credit Risk, the outcome is derived from the input of internally defined values into a global one size fits all formula defined in Basel 2 updated by some refinements in Basel 3.

   The consequence is that the internal approaches are the institution's internal approaches to derive the inputs into the IRB formula, namely the PD, LGD, EaD and maturity values. With respect to SMEs, it implies an assessment of the internal approaches to determine the sales turnover.

4) **Assist** the competent authorities in the assessment of the quality of the internal approaches. This is the responsibility of the EBA.

5) **Take corrective action,** *if it can be clearly identified that an institution's approach leads to an underestimation of own funds requirements which is not attributable to differences in the underlying risks of the exposures or positions*. This is the responsibility of the competent authority.

In addition Article 78 (6)

> *EBA <u>may</u> issue guidelines and recommendations in accordance with Article 16 of Regulation (EU) No 1093/2010 where it considers them necessary on the basis of the information and assessments referred to in paragraphs 2 and 3 of this Article in order to improve supervisory practices or practices of institutions with regard to internal approaches.* It is clear that the EBA is under no compulsion to do so.

The primary responsibility of the EBA

The only mandatory requirement of the EBA as set out in the Directive is the second subparagraph of Article 78 (3)

> *EBA shall produce a report to assist the competent authorities in the assessment of the quality of the internal approaches based on the information referred to in paragraph 2.*

The primary responsibility of the Competent Authority

The primary objective of Article 78 is to establish a process to enable competent authorities to decide what action should be taken with respect to *"an underestimation of own funds requirements (OFR)"*. [20]

In doing so it requires a competent authority to:

- *Make an assessment of the quality of those approaches* and
- base its decision on differences "*which is not attributable to differences in the underlying risks of the exposures or positions*".

The other way to express the requirement of the competent authorities is set out their responsibilities as a positive statement extracted from Article 78 (4):

If
- it can be clearly identified that an institution's approach represents the underlying risks of the exposures or positions, and
- the institution has used the risk measures correctly as inputs into the IRB formula (taking into account overriding regulatory parameters set by the competent authority)

Then
- it follows that the output must be a correct estimation of the OFR / RWA, and
- the competent authority shall take no corrective action.

This leads to the following fundamental questions:

1) Do the templates set out in ITS Annexes contain the appropriate data from which to derive conclusions?
2) Are the statistical benchmarking values as set out in RTS Article 3 robust and conceptually sound measures to indicate an underestimation? And also as a bi-product do they enable a determination of institutions where the estimation is reasonable and or an over-estimation.
3) Will the RTS, ITS and the EBA Report provide competent authorities with the information necessary to reach an opinion with respect to modelling of the drivers of risk?
4) Can a competent authority determine if there is an under-estimation of the OFR / RWA?

[20] With the exception of Operational Risk and local currency exposures to Central Banks and Governments funded in local currency

Timeline for reporting- and rotation of Assessments

In RTS Article 1

> *Competent authorities shall share the assessments made in accordance with Article 78(3) of Directive 2013/36/EU within three months after the circulation of the report produced by the EBA as referred to in the second subparagraph of Article 78(3) of Directive 2013/36/EU.*

However, the ITS and RTS do not set out any other dates by which institutions will be required to report data, EBA will issues its report, competent authorities will complete its review and issue statements on actions taken on an institution.

The EBA has stated that "*considering the potentially significant workload for institutions and competent authorities, the initial set of benchmarking portfolios is limited in number and a rotation approach to running the yearly assessment has been introduced for credit risk.*"

Page 59 sets out the approach for rotation: *Institutions are required to submit data for*

- *low default portfolios (LDP) (central governments and central banks, institutions and corporates – other) in 2016 and 2018, and*
- *high default portfolios (HDP) (i.e. retail – secured by immovable property SME, corporates – SME, retail – other SME, retail –secured by immovable property non-SME) in 2015 and 2017.*

Comments and recommendation

The EBA should set out a high-level schematic for these deliverables so that institutions, the EBA and competent authorities as well as the market place (shareholders, investors and analysts) are aware of the dates. The dates should take into account the dates for Pillar that have already established with respect to COREP and FINREP. Also the EBA should take into account the timelines and publications of annual stress-testing.

As explained above the reporting requirements are a significant duplication of other reporting templates (COREP and FINREP). This does not even take into account the templates that each competent authority has established (and continues to modify) for its stress-testing exercises.

We believe that the workload for institutions, the EBA and competent authorities would be significantly reduced by a harmonised set of data requirements to cover reporting (COREP and FINREP), benchmarking and stress-testing. It therefore seems to institutions that the primary reason that the rotation of assessment of LDP and HDP credit risk portfolios is to ease the burden of work on the EBA and competent authorities.

As set out in this response, there are downsides to this approach

The primary reason is that the credit risk OFR for each of these portfolios in isolation is not a measure of risk. It is only when the expected loss (estimated by institutions) and the total loss and unexpected losses (calculated by the BCBS) is calculated in aggregate and that also an institution has diversified portfolios covering all of those portfolios does there even become to be any sense in conducting an assessment.