Nederlandse Vereniging van Banken

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European Banking Authority
via e-mail: EBA-CP-2013-02@eba.europa.eu

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Subject: NVB Reaction to EBA CP2013/02 on extensions and changes to IRB, IMA and AMA

Dear Sir, Madam,

On behalf of the Dutch Banking Association[1] (NVB), I would like to thank you for giving us the opportunity to react to Consultation Paper 2013/02 "*on the conditions for assessing the materiality of extensions and changes of internal approaches when calculating own funds requirements for credit, market and operational risk under articles 138(5), 301(3)(a) and 352(3)(a) of Regulation (EU) XX/XXXX of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms [CRR].*" The process regarding significant changes to internal models is critical in ensuring consistency and appropriateness of internally assessed credit-, market- and operational risks. Regulatory overview of the internal models and the RWAs that result from those models is therefore warranted.

Although regulatory insight is warranted, the expected workload that will result from the current proposal is worrisome, as the number of "Material changes" and "Other changes" is expected to increase sharply.

This increased workload will be felt, both by banks, and by competent authorities. We expect the workload will at least be double the current one. In certain cases, this may be very well justified, but in others this certainly is not. We therefore urge EBA to rethink the suggested approach, and to assess the expected relationship between the expected benefits vs. the additional operational requirements.

We suggest to simplify the procedures into changes that are either significant, for which regulatory approval before implementation is required and non-significant changes, for which yearly notification is required.

We feel the proposed overemphasis on reporting of "Material changes" and "Other changes" reporting does not properly reflect the current set of tools the competent authorities have at their disposal to regulate proper internal risk modelling, nor does it take into account the internal processes banks have to ensure the quality of the model building- and review processes.

[1] The Dutch Banking Association (NVB) is the representative voice of the Dutch banking community with over 90 member firms, large and small, domestic and international, carrying out business in the Dutch market and overseas. The NVB strives towards a strong, healthy and internationally competitive banking industry in the Netherlands, whilst working towards wider single market aims in Europe.

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The qualitative thresholds are presented relative to the risk-weighted assets per risk category (credit-, operational-, and market risk). However, in order to make sure available resources are used efficiently, the impact of the qualitative thresholds should be related to the overall capital level of the bank as well. A minimum threshold that is related to the change to the *overall* capital requirement of the bank should be used to make sure the qualitative criteria cannot trigger a “material change’, even thought the delta in RWAs might be very small, in comparison to the banks’ total RWAs.

The goal of a thorough supervisory review process is to safeguard a high quality of risk modelling practices as well as to ensure the capital requirements that result from those calculations are commensurate with the underlying risks. However, the suggested review process could seriously delay the implementation of model improvements, which could result in banks calculating RWAs based on a lower quality model, until supervisory approval is obtained. To reduce the risk of such incorrect capitalisation, a timeline should be set for the supervisory review process.

Especially for market risk, the time required for model validation could be shortened by allowing banks to validate the results by using historical market data, for instance the data from the past 20 business days. This would shorten the processing time of the parallel run. Allowing the use of historic data for validation purposes could be helpful, as it is the market risk area that will be faced with the most significant increases of the required documentation, which is derived from the expectation that relatively more changes to the market risk framework will be regarded as “Material changes”.

This concludes our main points. You will find answers to the specific questions raised in the consultation in the annexes to this letter. Also, we would like to draw your attention to the reaction that was submitted by the EBF, which we fully endorse. Should you have any questions or remarks based on our letter, please feel free to contact me at your convenience.

Kind regards,

Onno Steins
Advisor Prudential Regulation

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Annex: Answers to the specific questions and observations regarding the annexes

-General-

TITLE I
General rules for the assessment of the materiality of extensions and changes

Q1:
Are the provisions included in this draft RTS that specify the principles of categorisation of extensions and changes, sufficiently clear? Are there aspects which need to be elaborated further?

A:
In general, the provisions are sufficiently clear. However, in regards to article 2.5, an extension has to be implemented after the authorities' granted permission, as not implementing an extension also requires permission from the competent authorities. For the sake of transparency towards competent authorities and institutions, we suggest to add a –- time limit of 3 months for models that are supervised by one supervisor and 6 months for models that are supervised by multiple supervisors between obtaining permission and the required implementation.

-IRB-

TITLE II
Conditions for classification of IRB approach changes

Q2:
Are the provisions included in this draft RTS on the calculation of the quantitative threshold for the IRB approach sufficiently clear? Are there aspects which need to be elaborated further?

A:
Article 4(1) (a) (iii) is not clear for non-joint stock companies. Further clarification would be welcomed.

Q3:
Do you support the calculation proposal of the quantitative threshold for the IRB approach in terms of design of the metrics and level of thresholds? (Please also take into account the arguments provided in Tables 2 to 5 of the Impact Assessment)

A:
In general, we support the use of quantitative criteria, because these criteria are the most objective and provide the best guarantee that all banks will be treated in a similar way. Although the consequence of the proposed RTS will be that RWA increases do not result in a requirement to follow the significant change procedure according to article 3(1) (c), we still expect the number of significant changes to increase. This increase is caused by the lower 'RWA decrease' thresholds (compared to current standards) as well as the qualitative conditions stated in Annex 1. The increased number of significant changes, in turn, will increase the workload for both competent authorities and institutions.
Next to this, the 15% decrease within the range of application can trigger the significant change procedure for changes that are not material from a group wide perspective. This will lead to an increase in workload for both competent authorities and institutions in an area where the added value of having a significant change procedure is debatable. This issue can be solved by increasing the 1.5% as laid down in article 3(1) (c) (i) to 2.5% and by adding a minimum RWA size to article 3(1) (c) (ii).

Q4:
Do you support for the IRB approach the three month period for notification of the changes before implementation?

A:
The three months notification period will occasionally cause delays in the implementation process. Therefore, a shorter period would be more workable. We suggest decreasing the period to two months. However, the newly proposed requirement to notify the competent authority of non significant changes on an ex-ante and/or ex-post basis will result in a significantly increased workload, both for the competent authorities, as well as for institutions. From our perspective, the added value of ex-ante notification is expected to be limited, especially given the workload that would result from this change in policy. We therefore suggest not to introduce this category.

-IRB-

Annex I - CHANGES TO THE IRB APPROACH

For every new BU that is created, a significant change would be required to be raised. There should be a quantitative threshold that allows you not to raise a significant change if the portfolios are limited.

The issue of triggering a significant change procedure applies to every qualitative criterion. Here, minimum thresholds should be used. Annex I, title II, article 2 (a) until (g), in its current wording, for instance always triggers a significant change procedure.

It is unclear if “methodology used for assigning an obligor or a transaction to a rating system” pertains to a change in the model coverage or not. Further clarification is desired.

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-AMA-

TITLE III
Conditions for classification of AMA extensions and changes

Q5:
Are the provisions included in this draft RTS on the calculation of the quantitative threshold for the AMA sufficiently clear? Are there aspects which need to be elaborated further?

A:
The criteria are sufficiently clear.

Q6:
Do you support the calculation proposal of the quantitative thresholds for the AMA in terms of design of the metrics and level of thresholds? (Please also take into account the arguments provided in Tables 2 to 5 of the Impact Assessment)

A:
We support the use of quantitative criteria, because these criteria are the most objective and thus guarantee that all banks will be treated in a similar way. However the 10% threshold appears to be quite low. We prefer to use a 20% threshold. The workload that would result from the current proposal is significant for all risk types, including operational risk and the expected benefits are not always clear.

Q7:
Do you support for the AMA the three month period for notification of the changes before implementation?

A:
The three months before implementation will occasionally cause a delay in implementation. A shorter period, for instance 2 months would be more workable. The obligation to notify non significant changes on an ex-ante basis is new. As previously stated this category should ideally be removed, as the expected benefits will not outweigh the extra workload for banks and competent authorities. Also, it is not clear what banks have to include in the annual notification pack for non-significant changes. Finally, no clarity is provided as to how joint decisions will be reached within the required timelines.

Q8:
Do you support that for the AMA no quantitative differentiation between changes requiring notification prior vs. post implementation is made?

A:
There appears to be a mismatch between the question and the annex. Contrary to the question, the annex *does* contain parts that could be labelled as a quantitative differentiation. We therefore request EBA to clarify this question.

-AMA-

ANNEX 2 – EXTENSIONS AND CHANGES TO THE AMA

Part II- Changes to the AMA; Title II- Changes requiring ex ante notification to competent authorities; (4 a iii): "*(…) the length of the time series of loss data to be used within the calculation data set according to Article 311(2)(a) of Regulation (EC) No xxxx/20xx [CRR];*": This would mean that an extension of the time series would always require a 3-month ex-ante notification to the competent authority. We prefer the term "definition of the time series".

-IMA-

TITLE IV
Conditions for classification of IMA extensions and changes

General remarks
We appreciate that competent authorities want to ensure that no changes to models and systems are made, that are aimed at lowering the IMA required capital, without prior notification to the authorities. Also, there is no debate about the regulator's desire to ensure that no unintended and/or unwarranted capital reductions take place. When changes take place, they should be executed in a controlled way. However, the currently proposed list of approvals and ex ante notifications are such that most changes to market risk models will fall in either of these two categories. This is a result of extending the requirements for ex ante approval/notification, without any consideration for the materiality of the change. This approach will discourage banks to apply improvements and changes, which is further aggravated by the substantial documentation requirements for every single change. '

We therefore propose using the following principles instead:

a) Do not introduce the requirement for ex-ante notification. In case it is decided to keep the ex-ante notification requirement, the required documentation should be significantly decreased, in order to curtail the workload.
b) The approach in the current framework should be maintained. This is built around two types of situations; significant changes and other changes (that are not marked as significant). For significant changes, a complete set of documentation is required. The non-significant changes are to be reported to the competent authority on an annual basis. This approach allows the competent authority to monitor all changes, and it creates the opportunity to raise questions if required.
c) Only the inclusion of general classes of risk factors (such as commodities), should require ex-ante approval.
d) Clear methodological improvements should not require ex-ante approval. In any case, the documentation requirements for methodological improvements should be decreased in order to create an incentive for banks to maintain a high standard of quality regarding their models. An example is the use of different swap curves with different reset tenors, instead of just one swap curve. Such a clear improvement should be endorsed. In this example, the IMA capital requirement will increase, but even in the event where it would decrease, the inclusion of relevant factors in the IMA model should take place, as it is simply a fulfilment of regulatory requirements. Another example is the inclusion of dividend as a special risk factor. Dividend is not considered to be general risk factors, but a sub factor within the equities class. Such an inclusion should be considered an improvement and should not require ex ante approval nor ex ante notification.
e) We prefer not to include an additional quantitative differentiation. The differentiation of 10% between material changes and changes that require notification is already set at a low level. The addition of extra quantitative differentiation would only increase the burden for all parties concerned.
f) The framework should make it impossible for banks to significantly decrease their internally modelled RWAs without prior supervisory approval. In case a bank can analytically demonstrate that a change of the modelling approach will improve model accuracy (for instance by adding risk factors not previously taken into account), no prior approval should be required. A similar reasoning should apply to cases where the RWA is expected to increase as a result of model changes.
g) Change the allocation base of the changes to *all* RWAs, instead of only the market risk RWAs. A 5% increase of the RWAs for market risk is a conservative threshold, since market risk RWAs are typically the lowest in absolute terms of credit-, market- and operational risk. We expect the 5% threshold will render *all* changes to market risk models as significant going forward. By relating the threshold to market risk RWAs only, the focus of banks and

competent authorities will be skewed towards market risk changes. Here is a stylised numerical example of the expected behaviour: suppose that 95% of the RWAs stem from credit risk and 5% are due to market risks. If a model change leads to a relative market risk capital increase of 6%, this is classified as material, which would require supervisory approval. The 6% on market risk translates into 0.3% overall capital increase (6% times 5%). A 1.4% change in credit risk capital would not be classified as material, despite the fact that the impact on overall capital is over 1.3% (95% times 1.4%). This is more than four times as high as the market risk model change. This is inconsistent.

Answers to the questions

Q9:
Are the provisions included in this draft RTS on the calculation of the quantitative threshold for the IMA sufficiently clear? Are there aspects which need to be elaborated further?

A:
The provisions are sufficiently clear, except for the treatment of subsidiaries. The preference is to use one model at group level, accompanied by one significant change procedure. Increases that are due to improvements of models, as discussed in the introduction to this section, should not trigger a significant change procedure and small changes which would not be expected to have a specific impact on IMA should not require a threshold test.

Q10:
Do you support the calculation proposal of the quantitative thresholds for the IMA in terms of design of the metrics and level of thresholds? (Please also take into account the arguments provided in Tables 2 to 5 of the Impact Assessment)

A:
A 5% of own funds for market risk or 10% change of the model calculation result (associated with the scope of application of the specific IMA model) may well be immaterial at a group wide perspective, and may lead to an increase in workload for both the competent authority and institutions. A possible solution can be to extent (c) (iii) with an additional minimum absolute RWA size or an additional threshold based on a bank’s total RWA.

Q11:
Do you support for the IMA the one month period for notification of the changes before implementation?

A:
The proposed notification period will increase the amount of time required to implement model changes. Along with the suggested 60 day observation period, the expected additional documentation requirements, and the low thresholds, leads to the expectation that each change to an IMA model will result in significant paperwork and a process that will take at least six months to complete. This does not seem a practical approach, which will probably hamper model development, potentially decreasing model quality.

Q12:
Do you support for the IMA the 60-day observation period for the purpose of comparing the modelling result before and after a proposed change?

A:
The only way a bank can produce 60 days of figures, is to implement the suggested changes in a separate environment. Together with a three month approval and a one month notification, this would mean that a lot of the changes can only be used 4 to 6 months <u>after</u> finalisation of the model

in the test environment, unless it is allowed to run figures backdated on a separate environment (i.e. not in parallel with the production processes). The combination with the very broad range of changes included in the draft RTS, will result in a unworkable framework. Minor changes will have to be heavily documented and tested, which does not seem warranted. Needless to say, the parallel work streams will impose extra demands on the IT infrastructure. Therefore, the 60 day calculation requirement only seems appropriate for large scale changes, such as the inclusion of a general class of risk factor.

Q13:
Do you support that for the IMA for those modelling approaches which are only required to be calculated once a week (stressed VaR, IRC, and CRM) to compare only twelve numbers for Article 7 paragraph 1(c) (iii)?

A:
No additional remarks; similar points as the ones made in response to question 12 apply. Please also refer to the answer provided by the EBF to this question.

Q14:
Do you support that for the IMA no quantitative differentiation between changes requiring notification prior vs. post implementation is made?

A:
We prefer a quantitative differentiation because of the objectiveness of these criteria.

-IMA-

ANNEX 3 - EXTENSIONS AND CHANGES TO THE IMA

Title II:

1. *inclusion of product classes requiring other modelling techniques than those applied to existing products such as path-dependent products, or multi underlying positions according to article 356 of Regulation (EC) No xxxx/20xx [CRR].*

   This should only be applicable for institutions which are not involved in complex options. Within exotic options different models are used. A new model should not be a requirement for ex ante notification. Furthermore, we don't understand the reference to article 356. It should be clear that no impact assessment can be given for new products. We propose to provide an annual overview of new products.

2. an increase in the use of or percentage of proxies arriving from an extension according to Article 356 of Regulation (EC) No xxxx/20xx [CRR]

   This is an unclear requirement. Which extension is meant?

Part II changes to models
Title I- Changes requiring competent authorities' approval ('material')
Parts with no remarks are not shown.

1. Changes in the calculation of the effects of changes in market risk factors on instruments such as including additional sensitivity measures or a move from Taylor-approximation to full revaluation, according to Article 356 of Regulation (EC) No xxxx/20xx [CRR];

This is a clear improvement, essentially fulfilling regulatory requirements. We don't understand why this should be subject to approval. Ex post notification should be sufficient.

2. changes in the aggregation scheme such as where a simple aggregation scheme is replaced by an improved one, according to Article 356 of Regulation (EC) No xxxx/20xx [CRR];

Although the aggregation scheme is an improved one, we understand that this could lead to less conservatism and that this would require approval.

3 inclusion of material risk factors beyond those necessary when the model is extended to new product types;

In case of old product type this would be an improvement for which we would propose only a regular reporting. In case of a new product the materiality and impact can only be assessed theoretically, as the product is evidently not yet in the portfolio. Furthermore, it is unclear what is meant by 'beyond those necessary'. As all relevant risk factors are required to be modelled, this point is unclear and seems redundant.

4 changes to external data sources or the IT data landscape, in particular to the interfaces which result in amendments in the calculation of the internal model;

This is rather vague. It should only be applicable if broad ranges of data inputs are changed.

5 out-sourcing or in-sourcing of components which are material to calculating risk or validating the model, such as obtaining market data relevant to calculating risk and P/L, or the switch from licence-based use of a system ('computational module') to use of an application service provider ('ASP');

This requirement in not fully clear.

8 changes to the approach for identifying the stressed period in order to calculate a Stressed VaR measure, according to Article 354(2) of Regulation (EC) No xxxx/20xx [CRR].

Given that the stress period identification review has to be presented to the regulator any way this seems rather far stretched.

Part II changes to models
Title II -Changes requiring ex ante notification to competent authorities
Parts with no remarks are not shown.

2 changes in how the effects of risk factor changes are calculated such as change from analytical to simulation-based pricing model, according to Article 356 of Regulation (EC) No xxxx/20xx [CRR];

Only in case this would be applicable to a broad range of products should this lead to an ex ante notification requirement. In the normal course of business, banks will have many small improvements. This should be part of a regular reporting not ex ante notification.

5 changes in the calculation of the effects of changes in market risk factors on instruments, including changes in pricing models used to calculate sensitivities to modelled risk factors or to re-valued positions for the value-at-risk model or for the purpose of back-testing, according to Article 356 of Regulation (EC) No xxxx/20xx [CRR];

Banks will improve /adapt the individual pricing models on a regular basis. Only in case of a system wide change should a notification be required.

14 changes in the implementation of internally developed and implemented pricing models or use of proxy models;

Banks will improve /adapt the individual pricing models on a regular basis. Only in case of a system wide change should a notification be required.

16 changes to the valuation method with regard both to the economic profit and loss and to the clean profit and loss, such as move from mark-to-model to mark-to market, or vice versa, according to Article 355(3) and 358(2) of Regulation (EC) No xxxx/20xx [CRR];

These requirements have to be compliant with IFRS. Only changes to broad classes of products should require ex ante notification.

17 change to the organisational and operational structure of risk management and internal governance process, according to Article 357(1) of Regulation (EC) No xxxx/20xx [CRR] including any of the following: (...)

Regular changes will occur. The current wording of this requirement is much too broadly formulated. Changes to the organisation have no impact on the risk figures, as only staffing changes in key positions will impact the risk management processes. Ex ante notification should be limited to a restricted set of changes, or removed altogether. Other changes should be communicated to the competent authority in the course of regular reporting.

19 changes in the IT environment, including any of the following (...):

Only broad changes should fall under this requirement. For example, changing from market data provider for a single curve does not necessarily lead to a large change in risk figures. If the data quality is significantly better, such a change should not be delayed. Sometimes a change is also required because a vendor stops quoting a curve. This should not temporarily halt the reporting of risk figures. Section d, closing down a trading location should not be subject to ex ante notification, as there will be no risks remaining.

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-General-

TITLE V
Documentation of extensions and changes

Q15:
Are the provisions included in this draft RTS on the documentation requirements sufficiently clear? Are there aspects which need to be elaborated further?

A:
Not all the requirements are sufficiently clear, such as requirement (d) and (h). As a starting point the required documentation should be based on internal documents that are already available. As the NSAs are increasing their minimum documentation requirements, the workload is expected to increase even further.
For IMA the requirements for ex-post notification are not really clear. This will make impact assessments difficult. IRB models are segregated models for which independent changes can be measured more easily. In IMA models, however, all changes are aggregated, as there is only one model. Assessing the impact of every individual change will be difficult and would require multiple simultaneous parallel runs. This would be unduly cumbersome and does not provide any meaningful information, as the model has to be looked at from a holistic perspective.

Q16:
Do you support the view that costs arising for institutions from the documentation requirements included in the draft RTS are not expected to be material? If not, could you please indicate:
- the main cost driver: i) additional IT equipment, ii) additional on-going Staff/hours, iii) other (please specify).

A:
As can be concluded from our answers to the previous questions, we expect the amount of required documentation to increase significantly. We therefore do not share the point of view that these costs will be negligible.

Q17:
Do you support the view that the additional costs, for institutions, of computing the quantitative impacts of the implemented model extensions/changes are expected to be non-material, given that institutions already carry out impact analysis in the current framework? If not please indicate:
- the main cost driver: i) additional IT equipment, ii) additional on-going Staff/hours, iii) other (please specify).
- the implied % increase in total yearly costs of internal model management for credit/operational/market risk induced by the quantitative impact analysis (specify whether the costs arise only for some of the risk categories covered by the provisions).
- indicative monetary amount of these additional costs (specifying currency and unit).

A:
Given the answers given earlier, we do not expect these costs to be negligible. This is the case across all risk types, but the effect is most profound for market risk due to the higher than average IT requirements that result from the daily calculation requirements.

Q18:
Do you support the view that, for institutions, the costs of ex-ante/ex-post notification of extensions/changes are expected to be non-material? If not, please indicate:
- the main cost driver: i) additional IT equipment, ii) additional on-going Staff/hours, iii) other (please specify).

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- the % increase in total yearly costs of internal models management for credit/operational/market risk induced by the notification requirements (specify whether the costs arise only for some of the risk categories covered by the provisions).
- an indicative monetary amount of these additional costs (specifying currency and unit).

A:
We expect the workload to increase substantially for institutions. This is caused by the larger number of significant changes, the large number of obligatory notifications that is being suggested by EBA and the increased documentation requirements that were discussed earlier in the response to question 15. We expect these effects in all risk categories. The main driver of costs will be the additional staff required. This could amount to 1 or 2 FTEs *per institution*.