EBA/Op/2015/04

02 March 2015

Technical advice

For the purposes of the report pursuant to Article 78(9) of Directive 2013/36/EU

Contents

1. Executive summary

1. On 9 December 2014, the EBA received a Call for Advice (CfA) from the Commission requesting technical advice from the EBA to assess whether the benchmarking process, set out in Article 78 of the CRD, functions properly and whether any changes are needed to that Article to resolve any potential shortcomings in the process.

2. The Commission specifically requested that the EBA provide advice on several elements considered relevant to inform the preparation of the report for the European Parliament and the Council due by 1 April 2015:

   - An assessment of whether benchmarking has proven to be a useful instrument in achieving the objectives established in Article 78 to establish:

     i. Whether similarities or differences in the outcomes of the results of internal approaches across institutions are justifiable in the light of the risks incurred by those institutions: the EBA considers that benchmarking is indeed a useful tool (though not the only one) to help the competent authorities assess internal approaches and determine whether differences in RWAs are justifiable. The use of benchmarking is therefore considered a very important component of the supervisory and regulatory toolkit and the EBA supports the use of benchmarking exercises on a regular basis.

        The use of hypothetical portfolios, as opposed to actual portfolios, permits a more targeted identification of differences in modelled RWAs and is principally relevant for market risk. This is because portfolio characteristics that may drive differences in RWAs can be isolated and their effects reduced through analysis. In this context, the EBA recommends clarifying in the legal text that, for market risk, banks should provide the requested benchmarking data if they are able to, and have regulatory permission to, model the instruments included in each portfolio, without introducing major changes, regardless of whether the bank is actually holding the specific instrument or exposure in its books. For credit risk this is less relevant as hypothetical portfolios can be created only for Low Default portfolios by selecting real exposures from borrowers that are in common with other banks, and banks are required to provide data only if they have actual exposures towards specific borrowers.

     ii. Whether using an internal approach does result in an under-estimation of own funds requirements compared with the standardised approach: the EBA has some reservations as to whether the standardised approach could be a meaningful benchmark for assessing the potential under-estimation of own funds requirements computed using an internal approach. Prior to consultation of the

Technical Standards on benchmarking, the EBA decided to drop the use of the standardised approach as a benchmark for market risk. The EBA considered that, since market capital requirements are portfolio dependent, it would be less meaningful to determine own funds requirements on an individual instrument or small portfolio under the standardised rules and to compare it with the internal model outcome for the same portfolio.

Regarding credit risk, some jurisdictions, as well as the industry during the consultation, expressed strong reservations about the use of the standardised approach as a benchmark, mainly due to its lack of risk sensitivity. On the other hand, no specific suggestions were provided for external benchmarks that could be used to assess the potential underestimation of own funds requirements, as requested by Article 78. In this context, the use of backtesting or relative benchmarks across peer groups seems more appropriate at this stage than the use of external benchmarks. Several competent authorities (CAs) also highlighted the burden and, potentially, lack of data quality of ad-hoc standardised calculations. For this reason, in the final TS those institutions that do not currently compute the standardised approach have been waived from the reporting obligation until 1.1.2017. Hence, fully fledged results from a comparison of calculations using the standardised approach versus an IRB approach will only be available to the EBA in 2018. More specific conclusions will be derived once several exercises based on the TS have been conducted, especially after 2018.

- An assessment of whether the current scope of the benchmarking exercise is appropriate: the EBA considers that the current scope is very ambitious, both due to the number of institutions that it would involve and the amount of approaches that would have to be assessed. The EBA considers that some differentiation by nature, scale and complexity of institutions' activities might be appropriate, allowing less significant or less complex institutions' activities to be subject to reduced benchmarking exercises (e.g. no complex or immaterial portfolios) or less frequent benchmarking exercises. A rotation principle and materiality thresholds could also contribute to make the exercise more manageable. Also, exposures at solo or sub-consolidated level may be benchmarked less exhaustively if they have already been benchmarked at consolidated level.

- An assessment of the feasibility and utility of introducing a benchmarking exercise for internal advanced measurement approaches (AMA) for operational risk: taking into account the existing workload as well as the limited previous experience and technical difficulties that any benchmarking of operational risk would entail, the EBA does not consider appropriate to conduct benchmarking for AMA models in the near term.

- An assessment of whether the current mandates and legal setting of the benchmarking are appropriate or whether they need to be modified: the EBA considers that the current legal setting is inappropriate and strongly recommends that benchmarking portfolios, as well as detailed reporting instructions, are not adopted as part of Commission Implementing Acts, but that powers are given to the EBA to update regularly the portfolios and instructions on its website. This is due to the following operational reasons:

i. There is a need to redefine the market benchmarking hypothetical portfolios as well as the list of counterparties for the credit low default portfolios included in the ITS annexes on a yearly basis. Any ITS update has to go through a three month formal consultation and has to be legally adopted and translated. In addition, if the EBA intends to incorporate to the updated portfolios the lessons learned from previous exercises, there would have to be a drafting overlap with the analysis phase of the previous year exercise. All these elements put significant pressure on an already challenging calendar, since in fact the "benchmarking cycle" would be longer than one year.

ii. The lengthy and complex process of correcting potential errors in any legal text is another drawback of the current legal setting, since the specification of individual portfolios is generally subject to errors and typos that are very hard to rule out entirely.

iii. A comprehensive benchmarking exercise requires a swift Q&A process for participating banks and CAs within a tight time schedule. In these kind of exercises, Q&As are generally updated on a weekly basis. Due to these timing issues, this process should necessarily differ from the official Q&A procedure, which can only be initiated once a Technical Standard has been legally adopted and has to go through a relatively long and complex process before Q&As are finally published as part of the Single Rulebook.

- An assessment of whether the minimum annual frequency stipulated in Article 78(1) is appropriate: the EBA considers that conducting a fully-fledged benchmarking exercise under Article 78 of the CRD on a yearly basis is a major endeavour. However, if the EBA were given appropriate flexibility in terms of running benchmarking exercises in a proportionate manner, possibly including a rotation approach, an annual exercise could be regarded as appropriate.

- An assessment of whether the information on the benchmarking exercise is working properly, in particular, whether information-sharing practices among CAs on benchmarking results and on decisions about potential corrective action are sufficient to ensure the convergence of supervisory practices: the EBA is confident that there are enough safeguards in the legal texts to ensure that the relevant information regarding the conclusions from the assessment would be shared at the appropriate level in a timely manner. Regarding CAs corrective actions, due to the fact that they are referred to in paragraph 4 of Article 78 while the assessments to be shared are related to what is stated in paragraph 3, the final RTS do not stipulate any requirement to transmit the information on corrective actions to the EBA and other CAs. However, the EBA considers that this information is necessary to carry out EBA's tasks, such as the obligation specified in Article 107 of the CRD to report to the Commission on the convergence achieved in supervisory practices, including the ongoing review of permissions to use internal approaches or the mandate included in paragraph 6 of Article 78 to issue guidelines and recommendations to 'improve supervisory practices or practices of institutions with regard to internal approaches'. Accordingly, the EBA suggests clarifying in Article 78 that the sharing of information among relevant CAs and with the EBA also includes summary information about corrective actions.

- An assessment of whether the areas currently designated for particular attention of the CAs in their annual assessments are appropriate or whether modifications are needed: although it is really the EBA which is in a position to assess high or low diversity, rather than the CAs, the EBA considers that both the current legal text for this area and the areas for particular attention are appropriate.

2. Background and rationale

2.1 Introduction

3. Article 78 of the CRD establishes requirements for institutions, CAs and the EBA concerning the setup of a regular benchmarking process to assess the internal models used to compute own funds requirements (with the exception of operational risk). It also establishes requirements for the analysis of the results of that process and the need for potential corrective actions to be undertaken in cases where it is discovered that institutions' approaches lead to an underestimation of own funds requirements which is not attributable to differences in the underlying risks of the institution's exposures or positions.

4. Pursuant to paragraph 9 of Article 78 of the CRD, the Commission is required to submit, by 1 April 2015, a report to the European Parliament and the Council on the functioning of the benchmarking of banks' internal models. Should the Commission consider that the rules governing the benchmarking process need to be adjusted, the report would have to be accompanied by a legislative proposal.

5. With this mandate, on 9 December 2014 the Commission submitted a letter to the EBA seeking technical advice on whether the benchmarking process set out in Article 78 of the CRD functions properly and consequently whether changes are needed to that Article to adjust any potential shortcomings.

2.2 Timing of the CfA

6. The Commission submitted the CfA to the EBA late in the process and with a tight deadline (i.e. 1 March 2015). The late submission was intended to allow the EBA to gain enough experience on the functioning of the benchmarking exercises conducted pursuant to the RTS and ITS mandated in Article 78 of the CRD, whose original deadline was 1 January 2014. Due to resource constraints at the EBA, the high political sensitivity of the subject and significant practical implications for institutions, CAs and the EBA, it was not possible to deliver the standards on time.

7. On 30 January 2014 the European Commission submitted a letter to the EBA, agreeing to the EBA's request to postpone the deadline for the submission of the ITS and RTS from January 2014 to September 2014[1].

8. In practice, due to the minimum period of time necessary for the legal adoption of the TS and the time required for institutions to implement the IT solutions needed for the new reporting,

[1]The draft Technical Standards were finally submitted to the Commission on 17 February 2015.

this postponement meant that it was not possible to conduct an exercise based on the RTS-ITS in 2014.

9. However, the Commission granted this nine-month delay in the timeline provided that the EBA would agree an alternative solution with national CAs to ensure that a benchmarking exercise would be conducted in 2014.

10. Accordingly, in Q4 2014, based on its general supervisory powers, the EBA launched exercises to assess variability on 'Low Default Portfolios' and Counterparty risk modelling (both IMM and CVA) for a sample of EU banks. These exercises were designed to minimise the burden on the institutions and CAs, building either on previous exercises conducted by the EBA or leveraging on work conducted at Basel level.

11. Nevertheless, the introduction of annual benchmarking exercises pursuant to Article 78 of the CRD is a natural extension of the work already undertaken by the EBA. In this regard, the EBA has been actively assessing the variability of RWA and model parameters (such as PDs and LGDs) both for credit and market risks for quite some time. During 2013 and 2014 the EBA published five reports assessing variability on RWA: two interim reports on the consistency of RWA in the banking book, two interim reports on the consistency of RWAs in SMEs and residential mortgage portfolios as well as a report on variability of RWAs for market risk portfolios.

12. Thus, though no exercise based on article 78 CRD has been conducted to date, the experience gained by the EBA from previous work, the exercises launched in Q4 2014 and the discussions and compromise solutions which had to be adopted during the negotiation process of the RTS and ITS, allow the EBA to provide a meaningful preliminary assessment of the different issues requested by the Commission in the annex to the CfA, which relate to the functioning of the benchmarking process and not to the actual outcome of the exercise.

3. Response to the CfA

13. The Commission specifically requested that the EBA provide advice on several elements considered relevant to inform the preparation of the report for the European Parliament and the Council due by 1 April 2015.

3.1 Benchmarking as an instrument of prudential supervision

14. The Commission is seeking EBA's advice on whether benchmarking has proven to be a useful instrument in achieving the objectives specified in Article 78 to establish: (i) whether similarities or differences in the outcomes of results of internal approaches across institutions are justifiable in the light of the risks incurred by those institutions and (ii) whether using an internal approach results in the under-estimation of own funds requirements compared with the standardised approach.

15. Regarding the **first objective**, the EBA considers that benchmarking is indeed a useful tool to assess whether differences in RWAs can be an indication of the potential underestimation of own funds requirements; however, it should not be considered alone[2]. Benchmarking does not give clear-cut answers in all cases and supervisory judgement is always needed as part of any assessment. In addition, the extent to which differences in RWAs can be attributed solely to modelling choices varies depending on the kind of portfolio used. Notwithstanding the abovementioned limitations, it must be stressed that the EBA fully supports the use of regular benchmarking exercises as a key supervisory tool in the assessment of internal models. While this response sets out a number of potential improvements in the legislative framework, aimed at improving the efficiency and proportionality of the legal framework, the EBA fully supports the objectives and direction stated in article 78 of the CRD.

16. In this regard, the use of hypothetical portfolios, as opposed to actual portfolios, allows for a more targeted identification of differences in modelled RWAs. This is because portfolio characteristics that may drive differences in RWAs can be isolated and their effects reduced through analysis[3].

17. However, for credit risk this approach may not be as useful. Generally, the credit portfolios of European banks can be split into two main categories for the purpose of benchmarking. The first category would include homogeneous customers and a rather limited number of possible counterparties. The exposure classes of institutions and sovereigns fall into this category, as do

[2] The primarily source for assessing the correctness of the RWAs differences should be the institution's validation results, with particular emphasis on the backtesting results.

[3] For credit risk, even for the same portfolios losses could still vary due to due to differences in credit management. When losses differ, RWAs should also differ. For example, if banks start calling overdue obligors within the first week of a non-payment, for instance losses would stay significantly lower than for banks waiting 120 days before they contact the obligor.

large corporates[4]. The second category is much less homogeneous with factors such as local economic conditions, information asymmetry and business model heavily influencing the specific credit risk models of banks. Retail and equity exposure classes are prime examples for this, as are SMEs. Whilst for the homogeneous portfolios a comparison across banks can be achieved in a meaningful manner (e.g. by comparing down to actual individual client level), the risk parameters and RWAs from less homogeneous portfolios are more difficult to compare and some approximations are necessary.

18. Thus, the EBA would like to emphasize that, though certainly useful, benchmarking is not the only tool to assess whether differences are justifiable. In addition, since no exercise based on article 78 has yet been conducted and the scope of institutions participating in EBA exercises has been quite limited so far, any conclusions derived at this stage have to be considered with care. It is clear that more solid conclusions will be derived once several exercises based on the RTS-ITS have been conducted.

19. It is worth noting that during the negotiation of the TS some jurisdictions considered that the text of Article 78 was literally oriented towards the use of 'real' exposures and not 'hypothetical'. This interpretation stems from a literal reading of the first paragraph of the Article which states that institutions shall *'report the results of the calculations of their internal approaches for <u>their exposures or positions</u> that are included in the benchmark portfolios*'[5].

20. For market risk, this narrow interpretation of the mandate would imply that only a bank which has the exact same instrument in its books (i.e. the same IRS, CDS or debt reference) should model the specific portfolio.

21. In practice, such a narrow reading of Article 78 would produce a less useful exercise since very few (if any) of the instruments included in the market portfolios would be modelled or benchmarked.

22. Therefore, EBA's reading of Article 78 followed a wider interpretation for the market risk benchmarking. If a bank can and has regulatory permission to model an instrument by providing robust, reliable and unbiased estimation of the capital requirements, then it should provide the requested data, regardless of whether it is actually holding the specific instrument in its books[6].

23. The EBA recommends clarifying this point in the legal text.

[4] Incidentally, those clients also show lower PDs than other customers, so for the sake of simplicity the portfolios are often referred to as "low default", even though the default rate is not a deciding factor when assessing the possibilities of benchmarking.

[5] Potentially also Recital 74 which speaks of 'risks incurred'.

[6] However, the number of hypothetical transactions needs to be limited. In general, the risk calculation requires major effort of the banks and, for hypothetical transactions, the data quality might be compromised. Furthermore, the representativeness of such hypothetical transactions for the banks' portfolios is questionable. In credit risk the bank shall provide a low default portfolio rating only if it has an actual exposure.

24.Regarding the **second objective** stated in paragraph 3 of Article 78[7], the EBA has some reservations as to whether a benchmarking exercise could deliver a meaningful assessment of the potential under-estimation of own funds requirements of an internal approach compared with a calculation using the standardised rules.

25.Prior to the consultation of the TS the EBA decided to drop the use of the standardised approach as a benchmark for market risk. This decision (which was supported by the industry during the consultation) was taken since the EBA considered that it was meaningless to determine own funds requirements on an individual instrument or portfolio in the market risk framework. Due to the fact that market risk modelling metrics are entirely portfolio-dependent, the conclusions derived at individual portfolio level cannot be uncritically extrapolated to real firm-wide modelling outcomes.

26.In addition, due to this portfolio-dependent nature, a comparison between the standardised capital charge and the internal model metrics is not meaningful for small portfolios. The standardised approach in the market risk area is a 'building block' approach, which only allows limited offsetting and hedging within each risk factor. The standardised calculation implies adding relatively low capital charges when measured individually, which become significant for real large bank portfolio. This is in contrast to the internal model approach, which would generally deliver a significant charge when measured at instrument level (i.e. after adding up VaR, SVaR and IRC for credit positions). However, the diversification effect brings an important reduction in own funds when applied to large portfolios. Notably, this benefit is more significant the larger the portfolio is. A limited portfolio exercise can thus, at best, deliver only a partial assessment of both absolute capital charges and comparison with standardised own funds requirements.

27.Regarding credit risk, whilst the EBA decided to consult on the use of the standardised approach as a benchmark and also decided to maintain it in the final draft text, several CAs, as well as most banks during the consultation, expressed strong reservations about its use. The concerns related to operational issues (such as the additional burden and, potentially, lack of quality in the data delivered by institutions) but respondents also highlighted the lack of risk sensitivity of the standardised approach. According to their view, the use of the standardised approach might deliver wrong conclusions and incentives if it were taken as a floor rather than as a benchmark. On the other hand, no specific suggestions were provided for external benchmarks that could be used to assess the potential underestimation of own funds requirements, as requested by Article 78.

28.Accordingly, the EBA decided to retain the standardised approach for credit portfolios[8] though, in order to address some of the concerns raised, additional language was added to

[7] Recital 74 of the CRR also states '(…*) More generally, the competent authorities and EBA should ensure that the choice between an internal modelling approach and a standardised approach does not result in the under-estimation of own funds requirements'*

[8] For certain portfolios, such as retail, the use of back-testing could provide an effective contribution towards the objective of Article 78

recital 9 of the RTS clarifying that where standardised approach computations are considered in the assessment of credit risk models, their use should be only intended as benchmarks for assessment, rather than as floors. In this context, the use of backtesting or relative benchmarks across peer groups seems more appropriate at this stage than the use of an external absolute benchmark.

29. In addition, due to the burden that performing a standardised calculation might entail, institutions that do not currently compute the own funds requirements for credit risk resulting from the application of the standardised approach, are not required to report it until 1 January 2017. Hence, complete results from the comparison of calculations using the standardised approach versus an IRB approach will only be available to the EBA in 2018.

30. The lack of any fully-fledged exercises carried out pursuant to Article 78 hinders reaching any strong conclusion at this stage. More specific conclusions will be derived once several exercises based on the RTS-ITS have been conducted, especially after the 2018 exercise for which a fully phased-in exercise will be possible.

Box 1: Examples of possible limitations in comparing bank's results

The use of different exposure classes for the standardised and IRB approach for credit risk hinders any comparison.

The lack of a uniform definition of default, as well as differences in the level of materiality thresholds, also hinders the comparison between banks using internal approaches[9].

Banks using standardised RW that are not based on external ratings might render any comparison with the standardised approach as a benchmark less useful. Furthermore, the option to rate sovereigns within the European Economic Area makes a standardised benchmark useless for sovereigns.

31. The Commission also requested EBA's views on the need for further benchmarking exercises in the event of the introduction of risk-specific capital floors based on standardised approaches, as currently contemplated by international standard setters, or in the event of the introduction of a Pillar 1 leverage ratio requirement.

32. In this context, it is worth noting that, in accordance with Article 500 of the CRR, institutions using IRB approaches are still subject to an 80% floor until at least 31 December 2017. However, depending on the bank, this floor is either based on the Basel 1 framework (Directives 93/6/EEC and 200/12/EC) or on the CRR standardised approach for credit risk.

33. As regards international standard setters, the BCBS has published in December 2014 a Consultative Document on the use of capital floors based on standardised approaches

[9] However, it should be mentioned that in the near future, with the publication of the RTS's on these subjects, this issue should be largely addressed.

https://www.bis.org/bcbs/publ/d306.pdf. In this Consultative Document, the BCBS states that the use of standardised floors intends to '*ensure that the level of capital across the banking system does not fall below a certain level; mitigate model risk and measurement error stemming from internally modelled approaches; address incentive-compatibility issues; and enhance the comparability of capital outcomes across banks*'. Accordingly, if these objectives were achieved, the use of standardised floors would directly address the concerns about potential underestimation of own funds requirement while, at the same time, providing a permanent benchmark between both approaches[10].

34. While the introduction of standardised floors would make any periodic benchmarking for market risk unnecessary, for credit risk the standardised approach would still be a useful "absolute" reference at the asset class level.

35. In addition, if a Pillar 1 leverage ratio requirement is finally introduced, this ratio would not be based on standardised calculations at portfolio level (with the sole exception of the add-on component of counterparty risk exposures under the Mark to Market method for OTC derivatives). Accordingly, supervisory benchmarking would remain as a useful tool even after a Pillar 1 leverage ratio was introduced.

3.2 Scope of the benchmarking exercise

36. The Commission also requested that the EBA assess, based on the experience gained so far, whether the current scope of the benchmarking exercise is appropriate. Currently, Article 78(1) requires all institutions that are permitted to use internal approaches to calculate risk-weighted exposure amounts or own funds requirements to participate in the benchmarking exercise. It also requires that all permitted internal approaches be subject to the benchmarking exercise, with the exception of those used to calculate own funds requirements for operational risk.

37. The EBA considers that the current scope is very ambitious, due to both the number of institutions that it would involve (around 65 to 70 for market internal models and significantly more for credit risk) and the amount of approaches that would have to be assessed. The EBA does not question that all institutions using internal models should be subject to benchmarking exercises, but does note that there are other options, as suggested below, to ensure a good balance between resources and outcomes. As currently planned, the annual benchmarking exercise will be a very significant project and it is clear that CAs, institutions and the EBA will have to devote a significant amount of resources to it. Given the resource implications, it is important to ensure that the outcome can be meaningfully taken into account. An annual benchmarking exercise for all banks and all portfolios may even reduce the

[10] It is worth noting that the standardised approach for market risk is currently subject to a complete overhaul as part of the Fundamental Review of the Trading Book, mainly due to the problems stated previously, which make unviable its use as a credible fallback or floor for an internal model.

value of the benchmarking exercises, as EBA and competent authorities will not be able to exploit the information obtained optimally.

38. Considering the potentially significant workload for institutions and CAs, the initial set of benchmarking portfolios published has been limited in number but it was not possible to explicitly introduce in the technical standard a rotation approach to running the yearly assessment since its consistency with the legal text would have been disputable. Nevertheless, additional portfolios may be introduced and the initial ones may be adapted in the medium term in line with a progressive implementation and learn-by-doing approach, and following an assessment whether this extension of benchmarking scope is material. Updates to TS are always possible based on EBA regulation and, in the case of the benchmarking, they will likely be required in order to incorporate lessons learnt in previous exercises.

39. During the negotiation, many CAs suggested that proportionality clauses and/or materiality thresholds should be included in the RTS-ITS text. The introduction of some proportionality in the TS was possible only to a very limited extent, since the current legal text necessarily covers all institutions using internal models, regardless of its size or complexity.

40. The EBA considers that some differentiation by nature, scale and complexity of institutions' activities is appropriate and thus, strongly recommends introducing explicitly proportionality in the application of Article 78.

Box 2: Proportionality in benchmarking exercises

There are many ways to implement proportionality.

1. A possible proportionate application of Article 78 and the related technical standards could work as follows:

- Larger banks (e.g. GSII and OSII) and/or those with "material" exposures under IRB approaches would be subject to fully-loaded benchmarking exercises.

- Less significant or less complex institutions would be subject to reduced benchmarking exercises (e.g. no complex or immaterial portfolios) or less frequent benchmarking exercises.

- The rotation principle should be introduced so that the exercise can be based each year on specific exposure classes / portfolios.

2. In addition, some exposures at solo and sub-consolidated level may not be benchmarked or benchmarked less exhaustively if they have already been benchmarked at consolidated level (e.g. in the context of credit risk, by excluding LDP portfolios that are usually calibrated at the group level or benchmarking with standardised approach as well as simplifying back-testing).

41. In addition, the EBA recommends allowing the use of materiality thresholds to potentially exclude non-material portfolios from the exercise or subject them to less frequent assessments.

42. Finally, the Commission also requested EBA's views on the feasibility and utility of introducing a benchmarking exercise for internal approaches for operational risk. The EBA considers that AMA modelling pose unique difficulties that are very difficult to overcome in order to conduct a meaningful exercise.

43. Benchmarking operational risk has never been tried by the EBA and, from a theoretical perspective, would imply providing banks with a 5 to 10 year data base of losses, together with some mitigating measures that institutions would need to apply; banks would need to provide their AMA capital calculation based on the above hypothesis, which would be completely different from their real losses and the mitigating measures embedded in their organisations. Accordingly, it is doubtful that such a complex exercise would in the end deliver meaningful results and the number of institutions applying AMA methodologies is rather limited (around 30 institutions in the EU).

44. Taking into account the existing workload, and the technical difficulties abovementioned, the EBA does not consider appropriate to conduct benchmarking for AMA models in the near term.

45. In addition, the operational risk framework is currently under extensive review in Basel, with a consultative paper on a new standardised approach under consultation, so it would be sensible to wait for the regulatory picture to settle.

3.3 Legal setting and frequency of the benchmarking exercise:

46. The Commission requests that the EBA provides its view on whether the current mandates and legal setting are appropriate or whether they would need to be modified.

47. While, in principle, the RTS do not have to be modified over time, the ITS would need to be updated regularly, in particular to define the benchmarking portfolios. This is necessary to update the maturities and features of the instruments included in the portfolios used to assess market risk, even if the same portfolios are used for two consecutive years, as some of them would have already matured, or would simply present different features due to the passage of time. It may also be necessary for credit risk, as the list of counterparties for the low default portfolios needs to be updated and maintained regularly (i.e. due to insolvencies, merges, etc.).

48. Every update needs to be preceded by a consultation with the banks on the proposed portfolios. However, a three month formal consultation might not be the most efficient way to structure the consultation. The additional time required for any TS to be adopted and translated (between three and six months) also has to be considered and, finally, despite going through several rounds of reviews, previous experiences clearly show that the specification of

individual portfolios is generally subject to errors and typos that are very hard to rule out entirely. Accordingly, the lengthy and complex process of correcting potential errors in any legal text is another drawback of the current legal setting.

49. An additional challenge stems from the fact that, if the EBA intends to incorporate the lessons learnt from previous exercises, there would have to be a drafting overlap with the analysis phase of the previous year exercise. All of these elements put significant pressure on an already challenging calendar, especially as the "benchmarking cycle" would be longer than one year.

50. Finally, just as in any other comprehensive quantitative study (such as impact assessments or stress tests) these yearly exercises will require a swift Q&A process for participating banks and CAs. In these kinds of exercises, Q&As are generally updated on a weekly basis. Due to these timing issues, this process should necessarily differ from the official Q&A procedure, which can only be initiated once a TS has been legally adopted and has to go through a relatively long and complex process before the Q&As are finally published as part of the Single Rulebook.

51. Accordingly, the EBA strongly recommends that benchmarking portfolios as well as detailed reporting instructions are not adopted as part of Commission Implementing Acts but that powers are given to the EBA to update regularly the portfolios and instructions on its website.

Box 3: EBA powers – case of Regulation 680/2014

This approach has already been chosen in the context of another set of TS which were adopted by the Commission as Regulation 680/2014. This Regulation states in its recitals that 'Due to their very nature, validation rules and data point definitions are updated regularly in order to ensure they comply, at all times, with applicable regulatory, analytical and information technology requirements. However, the time presently required to adopt and publish the detailed single data point model and validation rules means that it is not possible to carry out modifications in a sufficiently rapid and timely manner that would ensure permanent uniform supervisory reporting in the Union. Therefore, the detailed data point model laid down in Annex XIV to Implementing Regulation (EU) No 680/2014 and the detailed validation rules laid down in Annex XV to that Regulation should be replaced by stringent qualitative criteria for the single data point model and validation rules which will be published electronically by the European Banking Authority on its website.'

52. The EBA is also invited to provide its views on the minimum frequency stipulated in Article 78(1), which requires that the benchmarking exercise be performed at least annually for all permitted internal approaches.

53. Conducting a fully-fledged benchmarking exercise pursuant to Article 78 of the CRD on a yearly basis is deemed to be a major endeavour. However, if the EBA were given appropriate flexibility in terms of running benchmarking exercises in a proportionate manner, including rotation of portfolios where necessary, an annual exercise could be regarded as appropriate, even if still burdensome.

3.4 Collection of data and sharing of information pertinent to the benchmarking process between competent authorities and with the EBA

54. The Commission has requested that the EBA assess, based on the experience gained so far, whether the exchange of information on the benchmarking exercise is working properly. In particular, aside from the institutions' communication with their CAs and with the EBA mandated in Article 78(2), the EBA has been asked to assess whether current information-sharing practices, if any, among CAs on benchmarking results and on decisions about potential corrective action, as stated in Article 78(4), are deemed sufficient to ensure the convergence of supervisory practices.

55. As it has been previously noted, no benchmarking exercise pursuant to Article 78 has been conducted to date. However, thanks to the experience gained by the EBA as a result of the previous and ongoing work on RWA variability, as well as from the discussions and compromise solutions which had to be adopted during the negotiation process of the RTS and ITS with their member states, the EBA is able to provide an assessment on this point.

56. The collection of benchmarking data from institutions is based on a common framework for regular data submissions a so-called Data Point Model (DPM), and XBRL reporting framework. This ensures an efficient collection and integration of data by the EBA, which is critical for an exercise of this magnitude; however, it also involves some additional implementation costs for institutions, which need some time to implement the IT solutions required. A reporting based on ad-hoc Excel templates (such as the ones used so far in similar exercises) would be easier and quicker to implement but this would not be the right approach for a recurrent mandatory exercise of this magnitude.

57. As regards the sharing of assessment results, the RTS acknowledge that CAs in a group have a legitimate interest in the quality of the internal approaches used in the group, as they contribute to the joint approval decision of the internal approaches in the first place, by virtue of Article 20 of Regulation (EU) No 575/2013, they also have a general obligation to cooperate and exchange information with each other and with the EBA and to share any information essential or relevant for the exercise of the other authorities' supervisory tasks, as referred to in Article 116 and 117 of Directive 2013/36/EU.

58. Accordingly, the RTS stipulate that CAs shall share with the EBA the modelling assessments made in accordance with Article 78(3), within three months of the circulation of the report to be produced by the EBA, which, in case the results are relevant, shall share the assessments with the other relevant CAs of the institutions belonging to a group.

59. Thus the EBA is confident that the relevant information regarding the conclusions from the assessment would be shared at the appropriate level in a timely manner.

60. However, regarding potential corrective actions, the majority of CAs have a restrictive view as to the kind of information which should be transmitted to the EBA and/or other authorities. According to their view (reflected in the draft RTS) the corrective actions are referred to in paragraph 4 of Article 78, whilst the assessments to be shared are related to paragraph 3, so no information on corrective actions should be transmitted.

61. This information is however necessary to carry out EBA's tasks and, in particular, to ensure the convergence of supervisory practices, as mentioned in the CfA.

62. In addition, the EBA is required by Article 107 of the CRD to report to the Commission on the convergence achieved in supervisory practices, including the ongoing review of permissions to use internal approaches.

63. Finally, the EBA generally issues guidelines to foster convergence in supervisory practices. Of course any supervisory actions that involve changes in internal model practices are particularly relevant in the context of Article 78(6), which explicitly states that the EBA may '*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*'.

64. Accordingly, the EBA suggests clarifying in Article 78 that the sharing of information among relevant CAs and with the EBA should also include summary information about corrective actions.

3.5 Competent authorities assessment

65. Article 78(3) requires CAs to make at least yearly assessments of the quality of institutions' internal approaches. The CRD obliges CAs making those assessments to pay particular attention to those approaches that exhibit significant differences in own fund requirements for the same exposure and approaches where there is particularly high or low diversity, and also where there is a significant and systematic under-estimation of own funds requirements. The EBA has been asked to assess whether the areas currently designated for particular attention are appropriate or whether modifications are needed.

66. The EBA considers that both the current legal text and the areas for particular attention are appropriate. However, it would like to note that CAs are not necessarily in a position to perform the first kind of analysis on their own (assessing high or low diversity), unless they have a significant number of institutions participating in the exercise (which would be the case for the Single Supervisory Mechanism).

67. Given that the EBA will have the aggregated data from all banks across the EU, the EBA would be able to perform an analysis of modelling approaches that exhibit significant differences and/or high or low dispersion. In this regard, CAs would assess those models that provide values considered as outliers in the EBA report produced pursuant to Article 78(3) but the

assessment of variability produced by particular approaches would generally be centralised by the EBA, which will consider the conclusions from this analysis when issuing guidelines as stated in Article 78(6).

68. The EBA will provide in its report not just the data necessary to perform the two kinds of assessment mentioned in Article 78(3), but also additional information that should allow CAs to assess the 'quality' of the internal approaches, as stated in paragraph 3.

Annex – text of Article 78 of the CRD.

Article 78

Supervisory benchmarking of internal approaches for calculating own funds requirements

1. Competent authorities shall ensure that institutions permitted to use internal approaches for the calculation of risk weighted exposure amounts or own fund requirements except for operational risk report the results of the calculations of their internal approaches for their exposures or positions that are included in the benchmark portfolios. 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.

2. Competent authorities shall ensure that institutions submit the results of the calculations referred to in paragraph 1 in accordance with the template developed by EBA in accordance with paragraph 8 to the competent authorities and to EBA. Where competent authorities choose to develop specific portfolios, they shall do so after in consultation with EBA and ensure that institutions report the results of the calculations separately from the results of the calculations for EBA portfolios.

3. Competent authorities shall, on the basis of the information submitted by institutions in accordance with paragraph 1, monitor the range of risk weighted exposure amounts or own funds requirements, as applicable, except for operational risk, for the exposures or transactions in the benchmark portfolio resulting from the internal approaches of those institutions. 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.

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.

4. Where particular institutions diverge significantly from the majority of their peers or where there is little commonality in approach leading to a wide variance of results, competent authorities shall investigate the reasons thereforand, 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, shall take corrective action.

5. The 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 and therefore do not:

(a) lead to standardisation or preferred methods;

(b) create wrong incentives; or

(c) cause herd behaviour.

6. EBA may 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.

7. EBA shall develop draft regulatory technical standards to specify:

(a) the procedures for sharing assessments made in accordance with paragraph 3 between the competent authorities and with EBA;

(b) the standards for the assessment made by competent authorities referred to in paragraph 3.

EBA shall submit those draft regulatory technical standards to the Commission by 1 January 2014.

Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulation (EU) No 1093/2010.

8. EBA shall develop draft implementing technical standards to specify:

(a) the template, the definitions and the IT-solutions to be applied in the Union for the reporting referred to in paragraph 2;

(b) the benchmark portfolio or portfolios referred to in paragraph 1.

EBA shall submit those draft implementing technical standards to the Commission by 1 January 2014.

Power is conferred on the Commission to adopt the implementing technical standards referred to in the first subparagraph in accordance with Article 15 of Regulation (EU) No 1093/2010.

9. The Commission shall, by 1 April 2015 and after consulting EBA, submit a report to the European Parliament and to the Council on the functioning of the benchmarking of internal models including the scope of the model. Where appropriate, the report shall be followed by a legislative proposal.