



**GL on PD
estimation, LGD
estimation and the
treatment of
defaulted assets**

—
**Joint aspects of the
estimation of risk
parameters**

Public Hearing / Workshop

EBA Offices, London, 19th January 2017

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DISCLAIMER



The material shown in this presentation is only meant to spark off a debate at the EBA public hearing and does not necessarily represent the final position of the institutions involved which responses are currently under discussion and will be submitted to the EBA in due course.

4. General Estimation Requirements

Overarching Comments

Segmentation principles, data requirements and human judgment principles welcome as providing clarity. Two points:

- ◆ There can sometimes be acceptable differences between segmentation used within the business and that used within models [P.15]
 - ◆ E.g. differences in business process due to the client exposure. Most prevalent in small business sector.

- ◆ The impact of human judgment cannot always be measured [P.22(b)].
 - ◆ E.g. inclusion of a risk factor on a model may have deleterious impact in the short term but may make the model, and the credit processes dependent upon the model, more robust to economic changes.
 - ◆ Provided that human judgment is not used to distort aggregate RWA, it should be permitted.

4. General Estimation Requirements

Overarching Comments

Conservatism framework, i.e. positive or negative adjustment plus positive MoC, generally welcomed as providing clarity but with significant concerns:

- ◆ Categories [P.24] should be seen as checklist of potential sources of uncertainty, not as mandatory MoC add-ons.
- ◆ Adjustments plus MoC defined as net positive [P.28]. This may not always be appropriate:
 - ◆ Error can exist but MoC appropriately zero (e.g. data relevance);
 - ◆ MoC can be inestimable: we may know that there is an upward bias on a parameter but be unable to quantify this (e.g. tightening of credit standards);
 - ◆ Unclear if exclusions can be made to data that lower RWA [P.28 vs. P.19, 21].
- ◆ Application at Risk Parameter level ignores interconnectedness of risk parameters: MoC applied to PD may logically have the opposite effect on LGD [P.26–28].
 - ◆ E.g. correction for missed defaults will increase PD but logically will lower LGD (additional defaults with zero loss).
- ◆ MoC may need to increase with time (temporarily), e.g. loosening credit policy [P.34(a)].
- ◆ Care needed to ensure requirements directed towards RWA adequacy and correct (i.e. economic) incentives NOT model optimization [P.25(c)(i)].
- ◆ Institutions required to rectify all estimation errors with timeline, only, subject to materiality. Only estimation errors that unjustifiably lower aggregate RWAs should require remediation. [P.33]

4. General Estimation Requirements

Overarching Comments

There are operational concerns also:

- ◆ What is the role of adjustments and MoC in regard of the Use Test?
- ◆ MoC may not be easy to compute as an adjustment on the final risk parameter, in particular where multiple MoC adjustments are required [P.30]. These may not add linearly. This may require multiple model versions solely for the purpose of quantification. Additionally, this will be difficult to monitor.
- ◆ How do institutions determine the appropriate level of MoC? How do we ensure consistency across institutions and jurisdictions?

Question 4.1: Do you agree with the proposed requirement with regard to the application of appropriate adjustments and margin of conservatism? Do you have any operational concern with respect to the proposed categorization?

- ◆ Further clarity needed on adjustment plus MoC framework
 - ◆ Purpose of MoC should be to ensure that aggregate RWA is not distorted. It should not be used as a vehicle for model optimization. Errors that do not distort RWA should not be required to be remediated;
 - ◆ Acknowledgement that MoC can be zero for a Category;
 - ◆ Interaction with data exclusions: can data exclusions be permitted that reduce PD/LGD/RWA?
 - ◆ Interaction between risk parameters;
 - ◆ Quantification of MoC and its direction over time;
 - ◆ Sum of MoC may not be linear.

- ◆ Operationally
 - ◆ Banks should be free to use models without MoC applied for internal purposes without violation of the Use Test;
 - ◆ Further work is needed to simplify quantification of MoC, in particular where multiple MoCs are required;
 - ◆ How large should a MoC be? How is consistency ensured?
 - ◆ Revision of the conservatism framework will potentially result in a large number of material change requests with commensurate costs.

8. Application of Risk Parameters

Overarching Comments



Overall, requirements appear reasonable.

Question 8.1: Do you see operational issues with respect to the proposed requirements for additional conservatism in the application of risk parameter estimates?

- ◆ It should be acknowledged that as triggers are remediated, that conservative steps to RWA and/or individual risk parameters should be removed. This should not require a Material Change request and approval.

9. Redevelopment, Re-estimation and Recalibration of Internal Models Overarching Comments



- ◆ Clarity that role of development and validation functions within annual review of estimates is defined by the institution [P.200].

- ◆ Question of desired outcome arises: optimality or acceptability? [P.200–202]
 - ◆ Role of cost/benefit analysis?
 - ◆ A decrease in discriminatory power is not necessarily significant [P.200(a), 202(b)].

- ◆ Major changes in credit policy can take time to impact [P.202(a)(ii)].

- ◆ Annex IV, although exemplary, appears directed towards model optimization and potentially introduces requirements by the back door:
 - ◆ Banks are incentivized to optimize models' predictability. Supervisory concerns should focus on appropriateness of RWA at aggregate level to ensure that these are not distorted.
 - ◆ Some triggers are relevant only in aggregate.
 - ◆ Some actions can only be decided when they occur or with reference to the rating system in question.

Question 9.1: Do you agree with the proposed principles for the annual review of risk parameters?

- ◆ In principle yes, but text suggests that the desired outcome is optimal models without consideration of cost/benefits to institution.
- ◆ It should be emphasized that Annex IV, if included in the final GL, is exemplary only. The purpose of paragraphs 198 – 205 should be to ensure that RWA is not artificially lowered.

10. Calculation of IRB Shortfall or Excess Overarching Comments

- ◆ General agreement.

Question 4.1: Do you agree with the clarifications proposed in the draft GL with regard to the calculation of IRB shortfall or excess?

◆ Yes.