

Guidelines on PD estimation, LGD estimation and the treatment of defaulted assets

**EBA workshop**

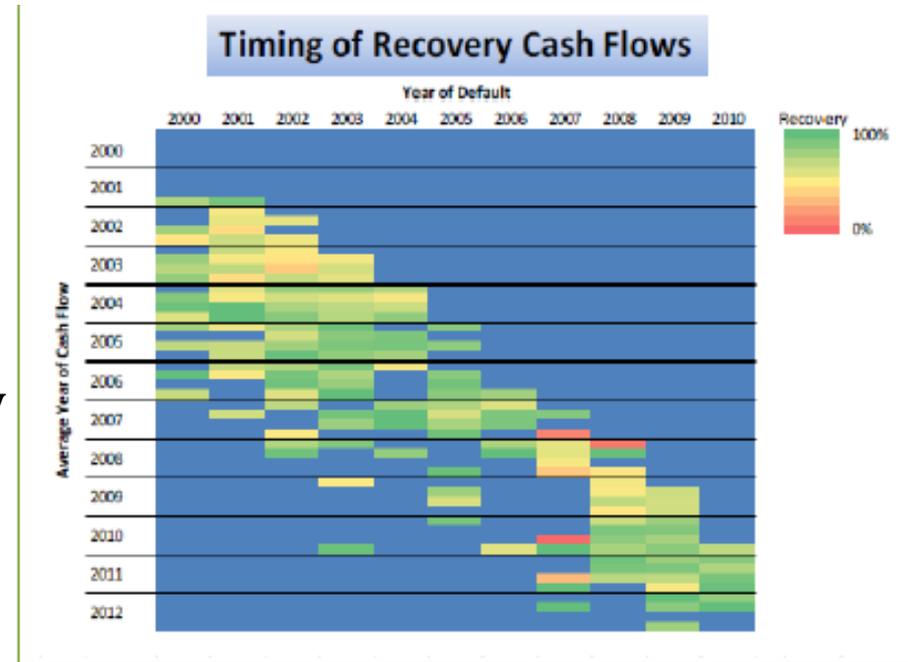
## LGD & defaulted assets

*Disclaimer: These slides have been drafted for the purpose of discussion in the abovementioned EBA workshop and do not represent the views of AFME or its members.*

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## Overarching comments

- LGD approaches should not unnecessarily separate the treatment of collateralised vs unsecured exposures as the recovery process is often managed at borrower level
- Time horizons matter:
  - Collateral is more than repossession
  - Portfolio diversification adds value and must be factored in to the analysis
    - For certain portfolios, a single LGD is applied for several vintages of performing *facilities* (with varying LTV levels...)
    - Strategies of repossession and recoveries can be optimised by banks over several years
  - See AFME's Downturn LGD Discussion Paper
- The Guidelines focus on statistical models. Expert/theoretical models, or pooled internal & external data may need different approaches



Source: GCD

## LGD estimation: Data requirements & other issues

*Question 6.1: Do you agree with the proposed principles for the assessment of the representativeness of data?*

- The proposal is relevant; firms routinely carry out representativeness analyses
- Comparisons should be made amongst defaulted contracts (modelled versus recently observed); comparisons between the defaulted portfolio and the performing portfolio make less sense.
- How should firms handle a lack of representativeness due solely to intrinsic differences between defaulted and performing exposures?
- Paras 93d and 143 look burdensome if compulsory, and may not necessarily lead to meaningful outcomes
- We would also welcome clarification on the expected consistency between PD and LGD databases (cf RTS 2016-03), especially on periods of observation and risk profiles (also in case of use of external data)

Attention points:

- Data accessibility in IT systems & other operational difficulties
- Data representativeness is a different issue when considering statistical v theoretical models

## LGD estimation: Calculation of economic loss and realised LGD

*Question 6.2: Do you agree with the proposed treatment of additional drawings after default and interest and fees capitalized after the moment of default in the calculation of realized LGDs?*

- Please distinguish additional recoveries charged by the bank to the borrower (restructuring fees...) when they correspond to economic gains. These should not be neutralised – they are actually recoveries.

*Question 6.3: Do you agree with the proposed specification of discounting rate? Do you agree with the proposed level of the add-on over risk-free rate? Do you think that the value of the add-on could be differentiated by predefined categories? If so, which categories would you suggest?*

- There is a wide range of views across the industry on this point, reflecting practice and accounting firms' requirements
  - The proposal of a single rate ( $BOR + \text{add-on}$ ) is simple and precise, and would limit RWA variability. The proposal could be developed to take the nature of the loan into account
  - Using cost of funding would be more accurate;  $BOR + \text{loan margin}$  could also be an alternative (note that for syndicated deals is the same)
  - Convergence with provisioning standards should be sought as much as possible, for instance via reference to contract rate or effective interest rate

*Question 6.6: Do you agree with the proposed principles on the treatment of collaterals in the LGD estimation?*

- Yes. See also our overarching comments

Attention points:

- Recovery cash flows from collaterals not recognised by CRR should be taken into account somewhere; agreement should be reached on this allocation (should it be on the 'prudentially unsecured portion?')
- Recognising the sources of the cash flows and allocating them adequately to the specific collateral or unfunded credit protection has operational challenges (collaterals may cover several exposures, operational difficulties in cases of disposals, etc.)
- Further work is needed on the link between collateral haircuts and the downturn component in LGD in order to avoid double counting of adverse events.
  - Shouldn't this be treated in the RTS on downturn and leverage on the market risk framework?

*Question 6.7: Do you agree with the proposed treatment of repossessions of collaterals? Do you think that the value of recovery should be updated in the RDS after the final sale of the repossessed collateral?*

- Yes. In addition to the final sale, the estimated value at the time of the repossession or the estimated value regardless of the repossession should also be stored to enable haircut backtesting

## **LGD estimation:** *Long-run average LGD and Downturn adjustment*

*Question 6.5: Do you agree with the proposed treatment of incomplete recovery processes in obtaining the long-run average LGD?*

- Banks' current treatment of unresolved cases in LGD estimates may lack consistency (roughly two thirds of banks use unresolved cases to some extent but techniques vary)
- The EBA proposals are broadly in line with industry practices.
- There should be a minimum period of observation for triggering inclusion in the sample, to remove too recent / absurd data points.
- Relatively long recovery procedures should be allowed when appropriate (i.e. reflects legal environment in some countries)
- As should the inclusion of future recoveries linked to collaterals for open cases on which collateral has not been used so far

*Question 6.8: Do you think that additional guidance is necessary with regard to specification of the downturn adjustment? If yes, what would be your proposed approach?*

- The proposals are in-line with methodologies and common practices, however additional elements are necessary to clarify the notion of downturn

## **Estimation of risk parameters for defaulted exposures:** *General requirements specific to ELBE and LGD in-default*

*Question 7.1: Do you agree with the proposed approach to the ELBE and LGD in-default specification? Do you have any operational concerns with respect to these requirements? Do you think there are any further specificities of ELBE and LGD in-default that are not covered in this chapter?*

- There is a wide diversity of practices in this area. Although some alignment is possible, some valid differences may remain
- Some firms directly build an LGDD model, and thus deduct  $UL = LGDD - ELBE$  (usually close to specific provisions, except for possible cost measurement or discounting effects)
- Some others model the UL component (covering downturn, MoC, volatility), and then deduct  $LGDD = UL + ELBE$
- In all cases, a proper backtest of the ELBE / specific provisions / final loss is necessary
- As a result, it may not be worthwhile imposing full convergence of methodological approaches on LGD for performing exposures to LGDD. Convergence could occur for the default series and treatment of the incomplete workouts. There is no obvious hierarchy between the values of LGDD and LGD for performing exposures

## Estimation of risk parameters for defaulted exposures:

### *General requirements specific to ELBE and LGD in-default*

*Question 7.2: Do you agree with the proposed reference date definition? Do you currently use the reference date approach in your ELBE and LGD in-default estimation?*

- Date of reference notion is meaningful (usually tested in model development but not systematically retained as not explanatory in certain cases)

*Question 7.3: Do you agree with the proposed approach with regard to the treatment of incomplete recovery processes for the purpose of estimating LGD in-default and ELBE?*

- This methodology seems consistent with the treatment of performing exposures, and thus relevant.

### *Specific requirements*

*Question 7.4: Which approach do you use to reflect current economic circumstances for ELBE estimation purposes?*

- Consideration of economics factors is usually done via expert judgment by sector, market of the equipment, or nature of collateral. Careful anticipation of future situation factors in the unexpected losses over the residual duration of the contract may trigger introduction of MoC as a forward looking component of the LGDD

Attention point:

We understand the requirement that LGD in default reflect a downturn cycle as the introduction of a new add-on (we do not find it in the RTS 2016 03)

## Estimation of risk parameters for defaulted exposures: *Specific requirements (cnt'd)*

*Question 7.5: Do you currently use specific credit risk adjustments as ELBE estimate or as a possible reason for overriding the ELBE estimates? If so how?*

- Firms should be able to maintain the use of provisions for ELBE
  - Little/no material reduction in RWA variance
  - Provisioning models subject to auditor scrutiny and public disclosure
  - Same supervisory/bank resource required
  - Change would not meet a cost/benefit test
- The conditions under which firms are able to use provisions should be widened so that development of new ELBE/redevelopment of existing IFRS9 models is not required

### Attention points:

- The two conditions allowing the assimilation of provisions to the ELBE are very restrictive: in particular demanding that the model of provision satisfy the requirements of the CRR, which is not always in line with auditors' requirements. We would welcome an alignment with EBA orientations provided in the CP2016-10 (ECL accounting)
- Nature of provisioning models can differ substantially according to type of portfolio (e.g. "HDP"/"LDP")