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**BANKING STAKEHOLDER GROUP**

CONSULTATION ON EBA/CP/2014/07 ON  
DRAFT REGULATORY TECHNICAL STANDARDS AND DRAFT  
IMPLEMENTING STANDARDS ON BENCHMARKING PORTFOLIOS

# General Comments and Replies to Questions

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## Foreword

The EBA Banking Stakeholder Group (BSG) welcomes the opportunity to comment on the Consultation Paper EBA/CP/2014/07 EBA Draft Technical Standards and Draft Implementing Standards on Benchmarking Portfolios.

This response has been prepared on the basis of comments circulated and shared among the BSG members and the BSG's Technical Working Group on Capital and Risk Analysis.

As in the past, the BSG supports an initiative that aims at harmonizing supervisory rules and practices across Europe, in order to ensure fair conditions of competition between institutions and more efficiency for cross-border groups. The BSG also expects these initiatives to facilitate data sharing between European supervisors and avoid reporting duplications for banks. However, the BSG identifies a number of issues which, unless properly addressed, could lead to unintended results.

This response outlines some general comments by the BSG, as well as our detailed answers to some questions indicated in the Consultation Paper.

## General comments

The Banking Stakeholder Group welcomes this opportunity to comment on EBA's draft Technical Standards and would like to draw attention to some general comments (this section), before addressing the specific queries included in the Consultative Paper. Whilst welcoming the document, the BSG has several reservations with respect to parts of the draft RTS.

A fundamental question to be raised concerns the utilization of the benchmark information by the NCA's. As is well described in the CP's background section, the challenge of assessment of the models developed and used by institutions still lies in the evaluation of the actual underlying risk models (using information which can be found in model development documentation, validation reports and other documents describing the IRB and IMM approaches used in different institutions). Also, other aspects regarding pre-conditions and relevant underlying working processes which vary across institutions could have direct or indirect impact on the own funds calculation, which should be considered. Because of this, BSG emphasizes that, it is of great

importance to involve banks at an early stage in the process, in order to mitigate potentially erroneous conclusions driven by lack of sufficient information on the subject.

The reporting requirements that will be needed to populate the described benchmarking portfolios are substantial and hence costly. Hence, every effort should be made to utilize pre-existing reporting systems, standards and regulatory authorised figures and parameters. The suggestion to base reporting on the already existing Data-Point-Model (DPM) is thereby welcomed.

We would like to note that the requirements for competent authorities when assessing the internal models as laid down in Article 8 – 12 are already described in the CRR for all model categories. For example, the requirements which have to be fulfilled for a market risk model approval are already defined in articles 365 to 377 of CRR, also differentiating between different risk categories and market risk models. Similarly, RTS article 10 para 2 refers to information related to the aforementioned articles of CRR, not differentiating between different risk categories and market risk models.

It would be helpful to clarify for which risk categories the respective requirement is of relevance, e.g. the requirement regarding “name related basis risk“ according to Article 10.2 (1) is only relevant for market risk models covering also the specific risk according to Article 370 CRR.

For the calculation and comparison of the Stressed VaR results, it might be necessary to provide a historical period which all participating banks have to apply (if possible). Otherwise each bank will apply its historical Stressed VaR period, which is determined by yielding the largest VaR for the bank’s current portfolio and might be different between the individual banks.

We agree with EBA on the presumed additional burden for banks regarding the Stress VaR calculation under a uniform stress period (page 16). Not all credit institutions have market data for each instrument under each stress period available. This holds especially true for stress periods from a long time ago. Nevertheless, a harmonization of the stress period appears to be useful with respect to a benchmarking exercise. We welcome this harmonization under the condition of a sufficient implementation period and a stress period defined in coordination with the credit institutions. We suggest as a starting date for the stress periods 2008 at the earliest to ensure data availability. During this interim period, potential differences in the Stress VaR might result from various stress periods within banks.

The CRR allows for a Partial Use of market risk models, e.g. using the internal market risk model only for some risk categories. This can distort the requested VaR results: some products are

relevant for several risk categories (e.g. currency swap, interest rate risk and foreign exchange risk), so maybe a reporting by risk category would provide more insight on the comparability of the modelled results.

Further clarification is needed in respect to what level of detailed feedback of the benchmarking results will be given to the participating banks. In particular, will banks receive the information on a counterparty by counterparty basis, where their internal rating for that specific counterparty ranks in relation to the internal ratings of all other banks for that counterparty? (e.g. in analogy to the large-scale credit reporting in the German KWG, where the Bundesbank reports back to the banks the median PD of the counterparty over all internal ratings reported by banks.)

## Replies to Questions

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

The use of common benchmarks would help considerably in the assessment of differences in capital requirement calculations across banks. Such an approach, based on well-established methods and definitions, would improve transparency regarding capital requirements in a given portfolio between different banks. However, given the approach outlined, it should be borne in mind that there are differences in the development of underlying risk models, which are difficult to compare and assess, since they could stem from practices and modeling choices whose effects on the capital requirement calculation are not explicitly measurable. In our opinion, the draft RTS does not sufficiently address these issues. Until these issues are resolved, there is a real risk that the proposed approach will prove to be counterproductive and will fail to identify the actual reasons for diversity across institutions' risk estimates.

In order to define the foundations for the benchmark assessment, effort should be applied to define how conclusions based on benchmark data should be drawn, and also when such benchmark assessments should be used. By means of examination of bank-specific approaches and supervisory practices across member states, common approaches could be established to the calibration of IRB parameters (PD, LGD, CCF and EAD) and to the definition of default and the treatment of defaulted assets. For this purpose, it is important to involve banks in the process, together with the NCA's. The BSG emphasizes the importance of benchmarking performed by each NCA to get an understanding of differences within a country. This will be performed in parallel as data is reported to EBA. The purpose is to increase the understanding of differences between banks and/or countries.

Q2. Do you consider that the benchmarks outlined in the RTS are sufficiently proportionate and flexible? Do you have any alternative benchmark proposals? If yes, please provide details.

The benchmarks outlined in the RTS seem reasonable and sufficiently flexible. However, the questions raised in response to Q1, as well as the limitations of the proposed benchmark, as described in response to Q3 below, should be taken into consideration prior to the adoption of the draft RTS.

The benchmarks proposed are largely unsuitable for the purpose described; there is a set of criteria which good benchmarks must fulfill, among them (i) clarity of definition and uniqueness, and (ii) stability in time over several benchmarking cycles.

RTS Art. 3 (2a) violates criterion (i) unless the absolute maximum and minimum of the sample are implied by the term “extremes”. RTS Art. 3 (2b) violates criterion (ii) in that the same number of portfolios (resp. models, resp. banks) will be subject to increased scrutiny and specific supervisory assessment in every benchmarking cycle, no matter what changes are implemented by banks as a result of the preceding benchmarking cycles.

To solve these issues, BSG proposes two changes to the RTS Art. 3 (2a) and (2b):

- RTS Art. 3 (2a): Replace the ill-defined term “extremes” by “outliers”. This term is defined in statistics, and there are easy operational procedures in descriptive statistics to detect evidence for outliers (cf. below). Moreover, we are convinced that an outlier – a data point a significant distance away from the body of a sample distribution – is a valid target for an assessment by supervisors,
- RTS Art. 3 (2b): Replace the metric of the first and fourth quartiles by the metric of outliers as identified by Box plots. A Box plot will display stability over time when most of the changes induced by the benchmarking procedure are in the outlier portfolios but will adjust moderately when a large fraction of the portfolios evolve over time.

On the other hand, the metrics suggested are unclear and unstable over time / across several benchmarking cycles, and excessive, at least. Actually, the metrics proposed in the RTS are inconsistent with Art. 78 (5) of the Directive 2013/36/EU.

Indeed, the instability over time can be due to the first/fourth quartile metrics when it can be imagined that all banks in these two quartiles react to the outcome, change their models, and essentially, in a second benchmarking cycle, produce numbers close to the sample median. In this second cycle, there will again be 50% of the banks identified as outliers although, as a consequence

of the banks changing their modeling, the first and fourth quartiles will be much closer to the median than in the first cycle.

After five benchmarking cycles with this metric, all banks will use the same standard model. Hence the metrics suggested directly contradict Article 78 (5).

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

With regard to the proposed use of quartiles (item (i) above), it serves the purpose of an indicative instrument, although it cannot help in the assessment of the actual reasons for differences between institutions in risk estimation based on internal models.

(i) The main limitation with the first and fourth quartiles is their stickiness on the sample distribution which is inconsistent with the idea of benchmarking. A solution is outlined in the answer to Q2, or alternatively, the use of the 90% and 10% quartiles could be more productive for the mentioned purposes.

The comparison of own funds based on the standardized approach and on internal models (item (ii) above) is of limited use, given that the standardized approach is not adequately risk sensitive. Hence such a comparison serves little purpose in the assessment of potential inconsistencies in the calculation of own funds based on internal models (which are, instead, more risk sensitive).

The situation is in fact worse than this, since the standardized approaches seem not to give the same RWAs in all banks for a hypothetical benchmark portfolio. These differences must be understood before using it in a benchmarking exercise. It is not risk sensitive and yet it still displays variation.

(ii) In line with the above and responding to question 3. (ii), it is worth mentioning that the calculation of a standardized approach is a laborious and costly procedure and should be avoided. With respect to benchmarking, it is based on the unproven hypothesis that internal models and the standardized approach evolve in line from bank to bank and from NCA to NCA. Unless the variability of the standardized approach is understood in some depth, it will obscure benchmarking rather than support it.

The use of the standardized approach as a benchmark presumes that it is related to the “true level of risk“. However, as it is a static measure it is not reacting to volatile markets, as the market risk models do. Moreover, banks using an approved market risk model for calculating RWA’s, usually do not have an implementation for calculating the standardized approach and any calculation under the standardized approach would cause an additional burden without legal foundations.

The comparison of estimates and actual outturns, (item (iii) above), would be suitable to form the foundation of the benchmarking exercise. However, methods for evaluating differences in rating philosophy between modeling approaches need to be further defined. Also, it is difficult to see how the differences across multiple institutions and their modeling approaches can be assessed and disentangled unless, in addition to the benchmarks proposed in the draft RTS, an in-depth analysis is conducted of model development (including validation documentation and other relevant reports, such as documents regarding the entire risk-classification system of the institutions under study).

It needs to be ensured that all participating institutions use the same definitions of default. Furthermore, it is obvious that a modification of the consideration of collaterals would lead to a change in Loss Given Default. A lack in handling both points would lead to distorted results.

Calculating the RWA on historical defaults and losses incorporates two problems:

Low default rates in wholesale portfolios lead to the problem that quite a lot of rating classes do not contain a default (depending on the size of portfolio).

This is especially problematic for the better ratings classes. Consequently an aggregation of rating classes is necessary to receive reasonable results.

To ensure a homogeneous determination of loss rates an EBA standard is necessary. Actually there is no specification given. Especially in the case of the one year horizon a determination of a realised loss is quite impossible because the duration of realisation is longer than the given horizon.

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

In our opinion the most appropriate approach would be to compare model estimates with an estimate based on actual long-term default rates and long-term credit losses.

Although EBA may question this remark by arguing that models work at the 99.9% confidence level, and data to validate that are not available, BSG suggests that EBA should identify auxiliary metrics for those cases where the target metrics would require too long time series, too much data, or do not provide sufficiently stable data. For example, validation of a 99.9% confidence level may not be feasible in practice either because of insufficient data, or because of the sensitivity of the quartile to small calibration errors. However, lower quartiles such as 90%, 95% or 99% have reduced data requirements and are more stable than extreme quartiles. Failure to validate such a low quartile indicates a wrong model.

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

The use of the TBG benchmark portfolio (annex VII b) could be especially useful for those institutions participating in the QIS on “Fundamental Review of the Trading Book (FRTB)” where the respective portfolios have already been integrated. On the other hand, a limitation to plain vanilla instruments could improve the comparability since not all institutions are able to evaluate double-no-touch-options and variance swaps. The exercise laid down in Annex VII (a) seems to be more extensive than the benchmark portfolio of the Trading Book Group. The requirements seem to be quite burdensome and from a cost-benefit viewpoint, a reduced set of instruments might yield the same results.

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

Although the approach on the whole seems appropriate for the purpose of benchmarking portfolio assessment across institutions, the extent of the information that will be requested calls for a prior establishment of the role and impact of the benchmarking approach as outlined in the RTS. This is in addition to the need for the establishment of well-defined methods of comparison of the risk assessment systems developed in the institutions across the EU.

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

No, we do not have any alternative proposals for future exercises



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

Option 2, on the basis of cost efficiency.

Question 9. Do you see any potential ambiguities in the credit risk portfolios defined in Annex 1? Please identify the relevant portfolio providing details and any suggestions that would eliminate these ambiguities.

Overall, the portfolio definitions seem adequate and reasonably well defined in conjunction with the accompanying information on the risk models defined in Annex VI, and a vast amount of data are collected to support the reporting for benchmarking purposes. However, there are potential differences regarding modeling practices, e.g. concerning rating philosophy, economic cycle definition, as well as adjustments due to data quality and the issue of conservativeness of estimates. These are not defined in the benchmark portfolio outline. These factors could be embedded in the model estimates and thus difficult to assess with regard to impact on capital requirement calculation.

Further clarifications are needed with regard to counterparties to be understood as legal entities, e.g. if ACME Inc. is listed as a counterparty in the sample portfolio, the information requested refers to the legal entity ACME Inc. and not to other entities / subsidiaries in the group of connected clients to which ACME Inc. belongs.

With regards to reporting on a consolidated basis, clarification should be provided on how to report credit risk parameters which are not identical within the banking group. For example, the same counterparty may have different ratings in different subsidiaries of the banking group or there may be different approaches to quantifying collateral haircuts in different subsidiaries. One possible approach would be to use the parameters of the group company with the largest exposure share for the sample portfolio. This might however result in a mismatch between the one specified PD and the overall reported RWA amount (calculated with the actual diverging PDs).

The portfolio of large corporates is defined as “annual turnover > EUR 200 min” in Annex I. Banks’ internal rating models for corporates are likely to have deviating turnover categories, e.g. one specific rating system may contain corporates with turnover above as well as below EUR 200. For data such as “default rate past 5 years” banks should be allowed to deliver this figure based on the turnover categories of their corporate rating systems, because it would be a laborious additional work step to calculate a 5 year past default rate based on a portfolio definition that does not correspond to the banks’ internal corporate rating system categories.

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

We have no further suggestions on additional credit risk portfolios for the purpose of benchmark assessment.

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

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

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

Yes, we agree that banks should have the possibility to refrain from reporting requirements.

It should be clarified whether basic IRB banks would need to complete the information for LGD (and EAD and maturity). While basic IRB banks use supervisory values for these parameters, the LGD still has a bank-estimated component in the case of physical collateral. For physical collateral (e.g. real estate), the collateral value that feeds into the LGD calculation, is determined by the bank.

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

It should be possible for a bank to abstain from the reporting of certain exposures based on their immateriality in individual clusters: that is, whenever the reporting of a specific cluster would be costly, but would not significantly add to the quality of the assessment of the institution.

Banks should also only calculate risks for those products and risk categories for which they have regulatory model approval (and only these results should be used for the regulatory benchmarking). This also has the advantage that all risk models used for the benchmarking process have undergone the same stringent regulatory approval process thus guaranteeing the application of comparable standards. The results will then be less distorted by effects which are not in the scope of the benchmarking exercise.

Submitted on behalf of the EBA Banking Stakeholder Group

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