Public Hearing on CP draft RTS on PDs and LGDs for default risk model for institutions using the IMA

17 September 2020

Recent cycle of EBA regulatory products under market risk

June 2019
Roadmap on new MKR and CCR approaches along with 3 CPs on 11 draft RTS* on the IMA under the FRTB

October 2019
CP on GLs on the treatment of S-FX positions

January 2020
CP on draft RTS on treatment of FX and COM risk in the BB under the FRTB

March 2020
11 final draft RTS* on the IMA under the FRTB

June 2020
CP on draft RTS on the calculation of the SSRM

July 2020
Final GL on S-FX

July 2020
CP on draft RTS on PDs and LGDs for default risk model under IMA

August 2020
CP on GL on criteria for the use of data inputs in the expected shortfall under IMA

Background: Legal basis

Article 325bp(12) - Particular requirements for an internal default risk model

- EBA shall develop draft regulatory technical standards to specify
    - the requirements that an institution's internal methodology or external sources are to fulfil for estimating **default probabilities** (PDs) in accordance with point (e) of Article 325bp(5).
    - the requirements that an institution's internal methodology or external sources are to fulfil for estimating **losses given default** (LGDs) in accordance with point (d) of Article 325bp(6).
- EBA shall submit those draft regulatory technical standards to the Commission by 28 September 2020.

Scope of the RTS (1)

Institutions permitted to use the IRB approach

- Paragraphs 5(d), 5(e), 6(c) and 6(d) of Article 325bp specify different treatments based on whether an institution has been granted - or not – IRB permission to estimate PDs or LGDs.
- Since IRB permissions are granted for certain exposure classes and rating systems, Recital 1 clarifies that the provision in paragraphs 5(d) and 6(c) should be understood as applying for the particular exposure classes and rating systems, for which the IRB permission has been granted.
- As a result, if positions within the scope of the DRC refer to issuers that would not be covered by the exposure classes and ratings systems included in the IRB permission, then institutions should apply the provisions of these RTS.

Scope of the RTS (2)

Institutions permitted to use the IRB approach

- TB positions are held with trading (or hedging) intent and are expected to change on a daily basis.
- OFRs for default risk are required to be calculated on at least a weekly basis.
- It is expected that assigning PDs or LGDs to TB issuers and financial instruments based on the existing IRB permission will generally not be possible within days.
- Recital 2 clarifies that institutions, even those with an IRB approval covering the relevant exposure classes and rating systems, should be understood to be allowed to temporarily use external sources, as delaying or suspending their TB operations until PDs or LGDs are derived from the IRB methodology would be disproportionate.

- Q1. What are the main challenges and most time consuming steps involved in using the IRB approach to be able to assign a PD and a LGD to a TB issuer and corresponding financial instrument, where such issuer is covered by the existing IRB permission, but no PD or LGD is immediately available under the IRB approach? How much time you expect is needed for an IRB approach to assign a PD and a LGD to a specific trading book issuer?
- Q2. What possible approach – other than external sources – could be considered until a PD and a LGD are calculated under the IRB approach for such issuer and financial instrument?

Requirements for internal methodologies

- Article 325bp requires institutions to use, over all other sources, PDs or LGDs estimated under the IRB approach, thus recognising the primacy of the IRB methodology for deriving PDs and LGDs.
- A level playing field should be maintained between institutions that have been granted the permission to use the IRB approach and institutions that have not.
- The RTS (Article 1(1) and 2(1)) specify that the use of an internal methodology should be possible only where such internal methodology fulfils all the requirements set out in Section 1 of Chapter 3 of Title 2 (IRB requirements).

- Q3. How are PDs determined for the purpose of the current IRC charge (Art. 372 and following of the CRR)? Are PDs derived from internal sources and/or derived from external sources? What is the predominant source (internal or external) currently?
- Q4. What are your views with respect to alternative internal methodologies (i.e. IRB equivalent, but different from the approach proposed here) that could be developed to derive PDs under these RTS? Are there any particular aspects and issues regarding TB dynamics that you would like to highlight?
- Q5. How are LGDs determined for the purpose of the current IRC charge? Are LGDs derived from internal sources and/or derived from external sources? What is the predominant source currently?
- Q6. What are your views with respect to alternative internal methodologies (i.e. IRB equivalent, but different from the approach proposed here) that could be developed to derive LGDs under these RTS? Are there any particular aspects and issues regarding TB dynamics that you would like to highlight?

Requirements for external sources

- The RTS (Article 1(2) and 2(2)) specify the requirements for external sources, reflecting similar qualitative requirements as those applicable to internal methodologies.
  - External sources should provide PDs and LGDs that are appropriate with respect to the institution's portfolio.
  - PDs and LGDs stemming from external sources should be validated on a periodic basis.
  - In case multiple external sources are used, a hierarchy of sources should be provided.
  - Specific documentation requirements should be applied (Article 3).
    - An up-to-date inventory of external sources used should be maintained, including:
      - a description of the methodologies used to obtain PDs and LGDs from external sources;
      - the results of the validation performed;
      - the hierarchy of the sources used.

- Q7. Do you have any additional comments on the general approach?

Next steps

3-month public consultation

Ending 22 October 2020

Analysis of feedback and amendments to the draft RTS

Finalisation and submission of the draft RTS to the Commission

Expected by Q2 2021

EUROPEAN BANKING AUTHORITY

20 avenue André Prothin CS 30154

92927 Paris La Défense CEDEX, France

Tel: +33 1 86 52 70 00

E-mail: info@eba.europa.eu

https://eba.europa.eu/