Draft RTS on the specification of the nature, severity and duration of an economic downturn

Public hearing, London 4 April 2017
Introduction
RTS on economic downturn

- **Expected timelines**
  - Publication of the Consultation Paper – 1 March 2017
  - End of the consultation period – 29 May 2017
  - Analysis of responses– 3rd quarter 2017*
  - Final RTS – 4th quarter 2017*
  - Implementation – by end-2020 (in accordance with the EBA’s opinion on implementation of 4 February 2016)

- **Interactions with Basel work** – the EBA is participating in the Basel work on the review of the regulatory framework on internal models and is closely monitoring its progress in order to align the timelines and requirements.

- **Relations with the GLs on PD and LGD estimation and the treatment of defaulted assets** will be taken into account when finalising the RTS

* Tentative dates depending on the number and nature of responses, potential controversial issues as well as progress in the Basel reforms
EBA’s review of the IRB Approach

- The RTS on economic downturn is part of the broader EBA work related to the review of the IRB Approach as described in the Report on the regulatory review of the IRB Approach published in February 2016.

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CRR mandate and consultation paper structure

1. **Draft RTS on the nature, severity and duration of economic downturn**
   - The draft RTS specifies the nature, severity and duration of an economic downturn (*economic downturn conditions*), in accordance with the mandates set out in Articles 181(3)(a) and 182(4)(a) of the CRR.

2. **Amendments to the downturn adjustment section of the GLs**
   - The mandate does not cover the methods used to reflect the economic downturn conditions into downturn LGD and conversion factors, as required by Article 181(1)(b) and 182(1)(b) of the CRR.
   - These are included, for the LGD, as proposed amendments to the downturn adjustment section of the GLs which are currently in a finalisation stage.

3. **Alternative simpler approaches to downturn LGD estimates**
   - Reference value approach – simplifies the methodological approach proposed in the RTS leaving more flexibility to institutions which downturn LGD estimates are challenged by a reference value.
   - Supervisory add-on approach – downturn LGD obtained as the sum of LRA LGD and a supervisory calibrated add-on reflecting portfolios realised losses.
1. Draft RTS on the nature, severity and duration of economic downturn
The proposed **model component approach** defines the economic downturn conditions as the period of time characterised by **unfavourable level of economic factors influencing relevant features of the realised losses/drawings**.

- **Economic factor approach**
  - **Downturn is driven by economic (both macroeconomics and credit) factors:**
    - Minimum list is provided,
    - At least one relevant economic factor for each model component.

- **Applied at model component level**
  - **Relevance of economic factors should be evaluated according to a (quantitative and qualitative) dependence analysis with model components:**
    - Model components as drivers of the realised losses/drawings multimodality,
    - Different model components may depend on different (relevant) economic factors.
Draft RTS - economic conditions as guiding principle

• The identification of the economic downturn solely depends on the worst value of the relevant economic factors and

• does not necessarily coincide with the highest observed credit losses (which could be idiosyncratic)
Draft RTS - main policy options

- Identification of economic downturn is based on an **economic factor approach**, where downturn is driven by macroeconomic and credit factors;
- Identification of the relevant economic factors according to their **dependence with model components** e.g. if the loss is driven by repossession (and/or cure rate) then house prices (and/or unemployment rate) could be considered as relevant economic factors.

- Application of a **one year** duration of an economic downturn for each relevant economic factor.

- According to the **worst value in the preceding 20 years** for each relevant economic factor;
- Longer or shorter periods allowed subject to certain conditions.
2. Amendments to the downturn adjustment section of the GLs
Amendments to the GLs – main principles

- **Prudential downturn LGD**
  - Computed at the grade or pool level (single exposure level for continuous models) according to the final downturn scenario selected in line with the RTS at the LGD model level,
  - Using realised or estimated value for each model component in the respective economic downturn periods which belong to the final downturn scenario.

- **Clarification around the RTS**
  - Margin of conservatism should be reflected when:
    - Nature of the economic downturn is based only on qualitative dependency between economic factors and model components,
    - The worst economic factor’s value in the preceding 20 (or more) years is not sufficiently severe,
    - Model component values are estimated during downturn period.
  - Severity: 20 years preceding the moment of LGD estimation.

- **Documentation requirements**
3. Alternative simpler approaches to downturn LGD estimates
Alternative simpler approaches

- The model component approach proposed in the RTS and the additional guidance on how to perform downturn adjustment to LGD appears relevant in order to ensure harmonised approaches across institutions and tackle RWA variability.

- This fairly prescriptive and methodological approach may be however quite costly to implement for institutions.

- The EBA is therefore seeking feedback also on two simpler alternative approaches for downturn LGD estimation:
  - The reference value approach
  - The supervisory add-on approach
Reference value approach

- **Simplifies the identification of economic downturn (RTS)**
  - Remove any reference to model components from the RTS
  - Nature defined along a minimum list of economic indicators (where relevant):
    - Removes requirements to perform dependence analysis between economic factors and internal LGD/EAD.
    - Methodology to evaluate the economic factors’ relevance is not provided.

- **Reduces implementation costs allowing institutions more flexibility to model their downturn LGD estimates**
  - Methodology to assess the impact of the economic downturn conditions on downturn LGD is not provided.

- **Confines institutions’ estimates through a non-binding reference value**
  - if $LGD_{downturn} < \text{reference value}$ institutions should use the reference value unless they are able to justify to supervisors that the reference value is not linked with downturn economic conditions.
Supervisory add-on approach

- **Reference is the LRA:** \( \text{LGD}_{\text{downturn}} = \text{LGD}_{LRA} + \text{Add}_{on} \)
- **Drops the economic factor approach and relies on observed credit losses**
- **Two options considered:**
  - **Distributional approach:**
    - Add-on is assessed at grade or pool level and captures the tail of the distribution (i.e. the variability) of observed losses across generation of default
  - **Downturn discounting rate with fixed add-on:**
    \[
    \text{LGD}_{\text{downturn}} = \text{Max}\left(\text{LGD}_{LRA;DR=\text{base rate}+5\%} + \text{Add}_{on}; \text{LGD}_{LRA;DR=\text{base rate}+10\%}\right)
    \]
    - downturn discounting rate (DR=base rate + 10%) takes into account time-in-default component.
    - Fixed \( \text{Add}_{on} \) could be calibrated at collateral type level to address interactions with Basel LGD floors.
Q&A session: structure

1. Q&A on draft RTS on the nature, severity and duration of economic downturn

2. Q&A on the amendments to the downturn adjustment section of the GLs

3. Q&A on alternative approaches to downturn LGD estimates