EBF\_013292D

*The European Banking Federation is the voice of the European banking sector, uniting 32 national banking associations in Europe that together represent some 4,500 banks - large and small, wholesale and retail, local and international - employing about 2.5 million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that securely handle more than 300 million payment transactions per day. Launched in 1960, the EBF is committed to creating a single market for financial services in the European Union and to supporting policies that foster economic growth. Website:*[*www.ebf-fbe.eu*](http://www.ebf-fbe.eu/)

11 March 2015

# EBF response to the EBA consultation on IRB Requirements

The EBF welcomes the draft RTS as a valuable step forward towards a harmonised approach to IRB within the single market. Although this document is necessarily directed towards supervisors, it can also provide valuable clarity regarding regulatory expectations and in turn facilitate greater convergence of IRB approaches between institutions and jurisdictions while preserving the essential objective of risk-sensitivity. As such, this RTS when finalised, will be a critical document setting out the direction and role of rating systems within banks’ risk management and capital management frameworks. Its importance and impact should not be underestimated. For that purpose, the EBF provides extensive comments in this response.

It is our opinion that such a critical document should outline, and provide the necessary detail for supervisors to execute upon, a vision of supervisory review. It is also our opinion that a core part of this vision must be to ensure that institutions have an efficiently-managed risk-sensitive decision tool fully integrated into their ever-developing business, risk management and capital management activities. In this respect, we believe that further work on the RTS as proposed should be considered.

**General remarks**

* This consultation paper attempts to create a uniform interpretation of supervisory assessment methodology and to ensure consistency in internal model outputs and comparability of the risk-weighted exposure amounts across EU member states; however, the consultation paper needs further clarification and detail on a number of points to achieve this.
* A Uniform and consistent interpretation of the IRB approach within the single rulebook is especially important for cross border institutions. Operationalising different rules in each country is difficult, costly and increases regulatory complexity (e.g. different supervisory practices for parameter estimation; reporting requirements; supervisory reference models to the parameters in IRB, among others). Therefore it is important that this consultation paper does not give mandate to further increased general supervisory judgements, such as add-ons or the use requirement, which prevent further harmonisation.
* The proposed text fails to make distinction between the roles of the different lines of defence, including the supervisory regime. It would appear that each line of defence is expected to replicate the role of the one beneath it. In particular the supervisory review fails to leverage the considerable investment by institutions in model validation and suggests an intensive supervisory review of all initial model proposals and subsequent changes. This will require a considerable investment in resources by the Competent Authorities with little supervisory benefit.
* The cost of compliance implied by the draft RTS is considerable. The proposed supervisory review fails to acknowledge that institutions are naturally incentivised to ensure that rating systems discriminate risk and therefore the focus of the supervisory review should not be to ensure model optimality but to ensure that capital distortions are kept to a minimum. Institutions, already incentivised to discriminate risk, are best placed to evaluate the cost and benefits of including or excluding risk factors. However we would support an exception where a systemic risk factor is identified for a group of institutions by a National Competent Authority.
* The framework is ill-suited to an environment where risk management of an institution is constantly developing and improving with consequent changes to an institution’s rating systems. The requirement for near-forensic examination by supervisors of model changes is a disincentive to investment in risk management and places an improper responsibility upon supervisors to examine all aspects of the proposed model or change.
* The objectives of the supervisory review are often left unstated and without clear priorities. A clearly-stated objective should be that capital requirements should not be distorted, as distinct from ensuring the optimality of rating systems.
* The framework repeatedly confuses economic cycle with long run average and these in turn with an observed observation period. Careful attention to these interrelated but distinct concepts would assist in ensuring that the framework is clear.
* A very significant concern is that the framework fails to acknowledge the recent economic experience of many Member States which have experienced significant market volatility. In particular, the proposal to exclude estimated data from estimates of the long run average default rate (Article 49(3)) may have significant macroeconomic consequences such as impacting lending capacity within many Member States and present a significant barrier to entry within the Single Market.
* We consider that the requirement established in article 49(3)(b) in order to determine the PD when the observed period does not cover a full cycle is against the Through-the-Cycle (TTC) philosophy of the Basel agreement.
* The proposed RTS fails to clarify the desired regulatory treatment for defaulted assets, a noted source of divergence and discretion between jurisdictions and institutions.
* No time limits for supervisory reviews are specified. Untimely supervisory decisions are a disincentive to improving rating systems with implications for the risk management of institutions.
* There is also a separate significant and demanding requirement for supervisory benchmarking (CRR Article 78). No reference to this as a supervisory tool is made within this proposed RTS.

It should be noted that banks have made considerable investments in the control frameworks surrounding the use of internal models within their independent model validation and separate risk-based audit activities. Banks are also naturally incentivised to discriminate between obligors on the basis of credit quality. The key supervisory concern therefore should be to ensure that the overall assessment and measurement of risk by banks is appropriate and consistent. The distinction, therefore, between model discrimination and model calibration should be made with supervisors concentrating efforts on the latter. This should additionally facilitate a more rapid supervisory decision process with real impact in ensuring that banks are correctly and appropriately assessing risks with a strong forward bias. In this respect, we would call for:

* A clearly stated strategy and focus for the supervisory review. This would delegate criteria of lesser importance fully to the control frameworks of banks. These latter would remain subject to supervisory review but on a risk-based assessment basis. The more important consideration of the risk assessment should form the core of the supervisory review.
* A clear exposition of the requirements for Long-Run Average PDs and the close but distinct relationship with the Economic Cycle. This must incorporate the legitimate use of estimated data within an appropriate framework so that banks can reflect new lending strategies within their risk assessments.
* A clear exposition of the requirements for downturn and long run estimates for LGD and CCF measures, to ensure consistency and again to ensure that the risk assessment reflects the lending strategies of banks which may be new.
* Clearly stated time limits for supervisory review.
* Elaboration of the principle of proportionality to provide an effective tool for the classification of banks and the consequent determination of supervisory expectations to ensure consistency across jurisdictions.
* Elaboration of clear expectations for independent model validation and for banks’ internal audit functions commensurate with roles appropriate to these functions.
* The opportunity to clarify the treatment of defaulted assets should be taken.

**Responses to questions**

***Q1: What views do you have on the nature and appropriateness of the proportionality principle in Article 1(2)?***

The principle of proportionality is referred to in the text but it suffers from a lack of definition and consequently it cannot be leveraged to provide additional clarity regarding supervisory expectations later in the text. In turn, the CRR states that the regulation should respect the principle of proportionality, in particular regarding the diversity in size and scale of operations and the range of the institution’s activities (e.g. simplest possible rating procedures, proportionality to the nature, scale and complexity of the risks associated with an institution's business model and activities).

The consequences of the application of the proportionality principle with regard to validation processes and number of required risk models and credit segments should also be considered under the light of the proportionality principle and, in particular, how all this will affect smaller institutions.

We propose that the principle is expanded upon, perhaps through a system of categorisation, and these categories can be linked to supervisory requirements elsewhere in the text (e.g. stronger governance requirements can be required of higher category institutions). This will assist in ensuring the appropriate and consistent application of requirements across jurisdictions and between institutions.

It is also important to determine whether the requirements will be applied on a solo basis or a consolidated basis.

The assessment of sequential implementation needs further explanation. For smaller portfolios or to entities we believe that a proportionality principle should be applied with a lighter assessment framework. We understand that roll out plans will have to be submitted for approval. We would like to know how, on which basis and how often this approval will take place.

With regard to the sequential implementation of the IRB Approach, the document sets a period of five years maximum for all exposures and business units. It is not clear if this change applies only to new AIRB applications, or if this change also affects ongoing roll-out plans. It needs to be clarified further how it should apply to existing applications. In the opinion of EBF members, this requirement should not apply retrospectively to the plans that have already been approved.

As it is set out in article 145 of CRR, an institution has to apply the requirements for the use of rating systems during at least three years before it can use the IRB approach for regulatory purposes. We would like to know if this minimum period of three years use test is required when the entity develops new ratings to replace the ones already in use. In case the new rating systems have been implemented for less than three years, we would like to know if it is sufficient to prove that similar systems have been in use for a longer period.

***Q2: Do you agree with the required independence of the validation function in Article 4(3) and Article 10? How would these requirements influence your validation function and your governance in general?***

In general the required independence of the validation function makes sense, however it is not clear as to what extent the level of separation of the functions should differ based on the proportionality principle. There is an opportunity here to utilise the proportionality principle but only if clearer indications are provided. The independence of the validation function, including separate reporting lines, may require considerable re-organisation by the bank. It could also lead to staffing issues, both in terms of hiring and retaining qualified staff. Creating a completely separate validation function may cause difficulties such as high turnover of qualified staff as the work can be seen as repetitive. Availability of experienced staff to conduct validation functions is limited and expensive. It goes without saying that such an important function should not be covered by inexperienced staff.

This chapter could include a 'comply or explain' approach, in which an institution that has come to a different solution from the one set out by the supervisors has the opportunity to explain why it has chosen that solution and to convince the supervisors that it is at least as efficient as the solution suggested by the supervisors.

These requirements would not fundamentally impact the validation function. This however depends on the interpretation of the proportionality principle.

Article 11, 3 (b): It is unclear as to whether this requires the validation function to test the deployment or ensure that the appropriate testing has been conducted. It is proposed that the responsibility on the validation function here is that the appropriate testing of the deployment has been conducted but not necessarily that those controls should lie within the validation team.

Article 17(1)(a) (The Role of Internal Audit): There is an apparent overlap in the lines of defence that may put unreasonable pressure on resource requirement, both in terms of numbers and of expertise. The result of the requirements may result in considerable investment of resources with little benefit. It would be proposed that a representative sample of rating systems would be more appropriate, considering the materiality of these rating systems. In particular the requirement that “all” rating systems are reviewed at least annually is particularly onerous. We propose that Article 17(1)(a) is revised to explicitly advocate a risk-based approach commensurate with the role of an internal audit function.

***Q3: Are the provisions introduced in Article 49(3) on the calculation of the long-run average of one-year default rates sufficiently clear? Are there aspects which need to be elaborated further?***

We consider that the requirement stablished in article 49(3)(b) in order to determine the PD when the observed period does not cover a full cycle is against the Through-the-Cycle (TTC) philosophy of the Basel agreement. In the ASRF (Asymptotic Single Risk Factor), on which the Basel framework is based, the PD used must be independent of the Economic Cycle (EC). Contrary to this philosophy, the application of article 49(3)(b) would make the PD dependent on the cycle, because the level of the observed default frequency (ODF) would be conditioned to the period of observed internal data. In our opinion, if the internal data is not representative of a complete economic cycle, the entity has to estimate a PD level not dependent of the cycle, and that estimated PD level could be lower than internal ODF as a result of the fact that the observed period of internal data is downturn.

How should default rates be determined for the artificial period? Default rates will vary depending on the institutions’ risk profile and it is therefore not considered appropriate that institutions apply the same default rates. This needs to be clarified in detail, to avoid situations[[1]](#footnote-1) where the supervisors set a fixed PD for downturn years for all banks, irrespective of their risk profile. A main purpose of internal models is to play a central role in the bank’s risk management by reflecting an accurate relationship between the bank’s risks and its exposures. This will not be the case if the regulators impose unrealistic restrictions on the modelling parameters. The level of default rate for IRB banks should also not result in disproportionate default rates compared to banks operating under the SA method.

Incompleteness of data covering the LRA, and/or one or more ECs, is a common problem for institutions. The requirement, “Application of different reconstruction methods should not lead to less conservative calculation of long-run averages of one-year default rates estimated from the observed data.”, is extremely problematic. Additionally this may act as a barrier to entry and decrease competition within these markets. The estimations may be limited to a timeframe that is not representative of an LRA or EC and therefore produce distortions in RWA outcomes and fail to incentivise institutions from improving their risk management practices.

The laws that require companies to publish their annual statements usually provide some flexibility regarding the exact date of publication, which typically allow for up to 3 months after the end of fiscal year. Thus, the information could not be available to comply with the 12 months requirements set in article 25(2)(b). This fact needs to be addressed accordingly.

Further clarifications would be necessary on the following issues:

The first sentence in Article 49 (3) states that PD estimation by obligor grade should be based on the long-run average (LRA) of one-year default rates. The term “by obligor grade” is not used in the rest of paragraph 3. Instead reference is made to “the default rates in given type of exposures”. In the text for consultation purposes the term “the default rates of the portfolio” is used. Hence, further clarification on the following is needed: Is LRA referring to the overall average for a given type of exposures across obligor grades or to an average default rate within each obligor grade, for a given type of exposures? In other words, is LRA defined across or within obligor grades?

Is point (b) an alternative to point (a) or is it mandatory after the reconstruction period is performed (as stated in point (a))? If it is mandatory, it is not clear if the requirement that “the reconstruction method estimated should not lead to less conservative PD than the ones calculated with the observed data” is applicable after the reconstruction method or, after the reconstruction method plus the conservative adjustments (specified in (b)).

There does not seem to be real value in option (i) of the reconstruction method (a) because the observed data is already representative of a complete economic cycle and consequently, no reconstruction method should be required. If the consultation text is maintained, the estimation of default rates not available for the period will probably lead to the construction of an overall period (observed + not available) different from the observed period, being this last one, by assumption, already a good representation of a complete economic cycle. Additional clarification would be needed as to the denominator of the one-year default rate (article 49(2)(a). We would like to know if it is required to weight the non-defaulted obligors that have no exposure during a period of one year.

Regarding option (ii) of reconstruction model (a), the construction of an artificial period to achieve a complete economic cycle can originate an aggregate lower PD than the one estimated based on the observed data. This possibility conflicts with the requirement set in the proposal that “the estimated PD of the construction method should not be lower than the ones obtained by using the observed data”. We propose the removal of this last statement to ensure consistency throughout the document. If the purpose of the reconstruction model is to effectively capture historic default rates that are higher than those currently experienced, then this could be expressed more clearly in the RTS.

Further guidance on how to assess the representativeness of the historical data period should also be provided in order to avoid different interpretations from local supervisory authorities and to minimise the possibility of adopting an approach that is later found not to abide by the regulatory requirements.

***Q4: Do you agree with the required number of default weighted average LGD calculation method introduced in Article 51(1)(b) and supportive arguments? How will this requirement influence your current LGD calculation method? More generally, what are your views as to balance of arguments for identifying the most appropriate method?***

There needs to be a better comprehension of the purpose of the two components of the Expected Loss and Unexpected Loss, namely EAD and the loss % (PD and LGD) for non-defaulted exposures:

* EAD defines the quantum of exposure;
* PD and LGD defines the riskiness.

We agree that for high-default portfolios in which there is an absence of any EAD concentration risk (granularity risk) that a default-weighted LGD calculation is appropriate and is consistent with the approach to PD.

However, for low default portfolios and or those portfolios containing concentration EAD risk then it is prudent to take into account in some way the riskiness of each exposure.

We recognise that an institution is required to take into account concentration (granularity) risk in its ICAAP and Competent Authorities are required to assess this risk in the Pillar 2 assessment.

In practice, IRB institutions segregate their corporate portfolios by size, such as Large Corporates, Medium Corporates and SMEs and Retail portfolios between mass-market and private banking. Thus the modelling of PD and LGD for these differentiated portfolios takes into account the actual losses and actual LGD.

However, for some institutions where it may be impractical to segregate portfolios, and or where it may have a concentration risk, then it would seem prudent to take into account this risk in Pillar 1 through an LGD estimate that reflects this risk, if an institution chooses to do so.

Therefore to the extent that an institution includes this risk in its estimate of ELGD, we consider that an exposure weighted LGD estimate should be permitted and in turn should have an impact upon a Pillar 2 assessment.

It is important to mention that significant differences are not expected between the two methods (default weighted vs exposure weighted) as the institution follows a cross-default approach on both defaulted customers identification and workout practices. The problem arises in jurisdictions where it is authorised a facility-based default definition for retail or it is required that the LGD calculation follows a facility approach, where the weighting scheme based on number of cases can distort significantly the estimates, lacking the adherence to real losses.

***Q5: Are the provisions introduced in Article 52 on the treatment of multiple defaults sufficiently clear? Are there aspects which need to be elaborated further?***

Additional clarity would be welcome around the assignment of the status of no longer in default (cured). It would be helpful if a more specific approach was given around when two default events are mutually exclusive, i.e. when a cure is really a cure so that future defaults are new events.

There needs to be further clarity of the requirements for consistency between any cure definitions used to treat multiple default events, and the definition of defaults and non-defaults for PD and LGD modelling and own funds calculations over time.

When a defaulted obligor is transferred back into a non-default status, it will be because any previous loss (if any) will have been written off and a new credit assessment of the obligor will take place taking into account a restructured balance sheet. That obligor is now to all intents and purposes a new obligor that is not connected to its past history.

Some aspects should be clarified:

Articles 52(a) and 52(c) are mutually contradictory. An exposure is either in a default or non-default state at any given time. Once an appropriate policy and practice has been established to establish this state by an institution then the default count follows. A borrower cannot multiply default during a period in which it is deemed to be in default. If there is a strong (statistical) propensity to re-default subsequent to a cure then the process by which that cure was determined should be examined. It is not appropriate that real defaults should be determined retrospectively. Article 52(c) should be re-phrased to clarify between the first instance of default, and the repeated breaching of default thresholds (i.e. 90 day delinquency) within a cure period.

We would like to know if in the case of an obligor that is in cure status, it would be possible to apply a PD different from an obligor in default (100%) but higher than the PDs applied to exposures in a non-default status, using a specific bucket properly calibrated.

Article 53(b): It is not always required that an institution compute both a long-run average and a downturn estimate to know which is the greater. This requirement should be clarified to recognise this.

Article 54: There is considerable divergence between jurisdictions and institutions regarding the treatment of defaulted assets and the relationship to provisions. The use of two possible approaches questions the objective of harmonisation. It is proposed that one approach should be required and the requirements of the single approach should be elaborated upon in detail.

Article 54(2)(e): The requirement for “all currently available and relevant information” should be clarified so as not to be interpreted to require that all possible information be known concerning a defaulted exposure, only that all practically available and reliable sourced data be considered for use in the evaluation of the exposure.

If the banks should use the definition of multiple defaults as outlined in Article 52, this definition needs to be clarified further to ensure consistent application across banks. This should include, for example, the definition of the length of the cure period during which multiple defaults are counted as one default. It should also define the explicit conditions for defining a facility as cured.

***Q6: Are the provisions introduced in Article 60 on the treatment of eligible guarantors for the purpose of own-LGD estimates sufficiently clear? Are there aspects which need to be elaborated further?***

Banks applying AIRB have already implemented own estimates for the collaterals they use, including guarantees. The same types of collateral providers (article 201) should be eligible under all approaches; however, the CRM technique and the effect of the guarantees will of course vary between approaches.

***Q7: Do you support the view that costs for institutions arising from the implementation of these draft RTS are expected to be negligible or small? If not, could you please indicate the main sources of costs?***

We do not share the opinion that the costs of implementing these measures are negligible or small. The proposed methods for PD and LGD estimations will lead to structural changes in the Financial Institutions models, namely for the ones that have IRB models aligned with current (IAS 39) and future accounting practices (IFRS 9). The following aspects will originate significant costs and could be a step back on the ongoing approval processes with the local supervision authorities:

Costs arising from the transformation of delinquency data sets according to the rules defined for multiple defaults. There is a possibility that this could not be achieved for periods before some cut off dates (due to specificities of IT systems or changes in the data recovery processes within the banks) which will lead to loss of statistical information and major pressure over the 5 year minimum threshold for observable data.

Unclear rules regarding the PD adjustment to reflect a complete economic cycle and the introduction of requirements regarding the reconstruction of periods for models in which the observed data is not representative, will lead to structural changes in the current PD models under the IRB approach, with major consequences across different business lines that depend on these models (e.g. pricing and loan granting).

A default weighted LGD approach will lead to an overall reconstruction of LGD models and to the evaluation of new segments, with consequences on the provision side of the Banks’ P&L which should be, in some extent, aligned with IRB models in order to overcome excessive shortfall deductions on CET1. There is also a significant level of uncertainty regarding the degree of the impact that such changes could originate on the current capital requirements and on the P&L side of the Institutions (due to changes in provisions).

If the time period of a maximum of five years for the sequential implementation of the IRB Approach is changed retroactively to apply to already approved plans, this could have a significant cost.

***Q8: What are the main benefits for institutions that you expect by the adoption of these draft RTS?***

Additional clarity has been provided in some areas however further work could achieve greater convergence between supervisory practices, with consequent benefits for consistency of outcomes for capital requirements and clarity for implementing institutions.

***Q9: Do you expect that these draft RTS will trigger material changes to the rating systems (subject of the RTS on materiality of model changes)? If yes, could you please indicate the main sources of the changes (please list the relevant Articles of these draft RTS)?***

The intensive supervisory review proposed by the RTS creates a risk that supervisors will pursue a policy of optimality of rating systems. Such a policy may require material changes in many rating systems or even minor changes but with similar costs to institutions.

The requirements of Article 49(3) will require revisions of many rating systems.

The lack of clarity regarding the definition of default and cure (Articles 26 – 29) may also lead to revision of rating systems.

Re-organisation due to changes to the validation function could result in a material change.

It is necessary for a precise assessment of changes that EBA makes clear how to deal will the interactions between this draft and earlier guidelines of national competent authorities.

**Other comments**

In some countries supervisory practices related to the inclusion of future and unquantifiable sizes of system risk or e.g. housing bubbles have resulted in overruling the banks’ internal models by requiring considerable add-ons and fixed, high floors to parameters, irrespective of the bank’s risk profile[[2]](#footnote-2). This is an issue which needs clarification in order to secure a more consistent approach.

A clarification of the conservative adjustments which should be applied to outdated ratings (older than 12 months) would be also be good, to ensure consistent treatment across institutions.

Regarding data quality, it should be specified that lack of historical data is dealt with in Article 49, so that the institution is not penalised twice for the same issue.

It is not clear the definition of a meaningful stress testing (Article 66). Supervisory add-ons are in some countries already added to parameters to meet future systemic risk in the real estate market. Should stress testing be performed on this data (which would mean stress testing data that already includes stressed data) or should it only be performed on internal estimates?

In CRR Article 178 (3) there is a list of 6 indicators of default labelled a) to f). In RTS article 27 there is a reference to the same 6 indicators of default, but in the RTS these indicators are now described as triggers of default. We believe that this is a strengthening of the wording which is not warranted in the CRR and we would suggest that the wording in the RTS is changed so that it is in line with the CRR.

EBF contact person: Gonzalo Gasos ([g.gasos@ebf-fbe.eu](mailto:g.gasos@ebf-fbe.eu))

1. As a point in case, the Norwegian supervisor has set a fixed PD of 3.5% for downturn years as well as floors in the PD and LGD dimension for mortgages for all banks irrespective of their risk profile. [↑](#footnote-ref-1)
2. For example, in Sweden: a risk weight floor for residential mortgages of 25%; in Norway: a PD floor of 0.2% and an LGD floor of 20% and a benchmark LGD model for residential mortgages. [↑](#footnote-ref-2)