ASF response
to the Consultation Paper Consultation Paper on Guidelines
on PD estimation, LGD estimation and Treatments of defaulted assets

As a unique representative body of all the French specialised credit institutions and financial institutions which represents 280 entities, ASF contributes to an appropriate recognition of the specialised financial activities like equipment and real estate leasing, factoring, consumer credit and auto loans and leases, mutual guarantee societies, investment firms and securitization arrangers, which – with an outstanding of more than €220 billion in 2015 – accounts for about 20% of total amount of credits to the real economy in France.

Q1

4.1 : Do you agree with the proposed requirement with regard to the application of appropriate adjustments and margin of conservatism? Do you have any operational concern with respect to the proposed categorization?

The EBA proposal doesn't give any element on the calculation methodology of the Margins of Conservatism (MoC), which could eventually introduce variability among institutions, opposite the EBA objective.
The definition of Category C (General estimation errors) is less detailed than the three others, and not precise enough. No concrete example is given (not even in the annex I p. 23).
The proposed methodology for the estimation of the MoC does raise operational concern since we understand that two calculations will be required: the estimation with the available data, plus the estimation with the corrected data. This would be burdensome, time consuming and complicated to implement.

The superposition of two levels of MoC (by type and global), in case there are several MoC required, seems significantly complex, and could reintroduce variability in the different models.
The proposed approach with a very granular and analytic vision on margin of conservatism may lead to the aggregation of numerous margin of conservatism that would have a significant impact in capital requirement, and most of all will put in question the value of operationality of risk parameter. Therefore, and in order to avoid duplicates, entities should have to possibility to some extend to assess and apply margin of conservatism in a global way, or even not to apply any margin if it can be demonstrated that the deficiency itself lead to a conservative outcome.

Q2

5.1 : Do you see any operational limitations with respect to the monitoring requirement proposed in paragraph 53?

General comment on paragraph 44:
Homogeneity is already required for pools of exposures in CRR (Art 170 (3)c)), then why would a MoC be required? What would be the criteria for homogeneity?

The requirement to calculate the one-year default rates at least quarterly will be difficult to implement and will request as a consequence IT development.

Due to the fact that the parameters are backtested and updated on an annual basis, it seems more approriate to have an annual review, but based on quarterly data.

Q3

5.2 : Do you agree with the proposed policy for calculating observed average default rates? How do you treat short term contracts in this regard?

The specialised activity of consumer credit mostly includes short term contracts. The requirement of an additional MoC would introduce undue divergence and variability in the models for this industry compared to other credit activity.

Q4

5.3: Are the requirements on determining the relevant historical observation periods sufficiently clear? Which adjustments (downward or upward), and due to which reasons, are currently applied to the average of observed default rates in order to estimate the long-run average default rate? If possible, please order those adjustments by materiality in terms of RWA.

General comment on paragraph 59-61:
The fact that PD estimation doesn't take into account most recent tendencies of the default rate would introduce complexity in back testing analyses (for instance when the latest default rate observed is superior to PD estimation).

Q5

5.4: How do you take economic conditions into account in the design of your rating systems, in particular in terms of:
d. definition of risk drivers,
e. definition of the number of grades
f. definition of the long-run average of default rates?

Currently, for some consumer credit institutions for example, economic conditions are only taken into account in the calculation of the long-run average of default rates.

Q6

5.5: Do you have processes in place to monitor the rating philosophy over time? If yes, please describe them.

Currently, some consumer credit institutions for example make studies to observe migration between the different risk pools.

Q7

5.6: Do you have different rating philosophy approaches to different types of exposures? If yes, please describe them.

For most specialized credit activity, the types of credit granted is usually “monoline”, meaning there is only one type of portfolio / type of exposure: ex. retail portfolio for consumer credit.
The “rating philosophy” is mostly the same for all the exposures.

Q8

5.7: Would you expect that benchmarks for number of pools and grades and maximum PD levels (e.g. for exposures that are not sensitive to the economic cycle) could reduce unjustified variability?

Benchmarks for number of pools and grades and maximum PD levels doesn’t seem relevant as regard to the heterogeneity of risk profiles and business models across the EU. It could be punishing for institutions which have a low risk profile.
To reduce heterogeneity, benchmarks would have to be realized by type of exposure, business models, localization… which seems too complex.

Specific business models such as consumer credit, leasing, guarantees…could be strongly impacted by the introduction of benchmarks of pools and grades and maximum PD levels: if same grades are applied for all business line, those specialized credit activities will be concerned by very few grades. It would be difficult to duly monitor the large scale of institutions business models / activities with a too low number of grades.

As a general comment, it has to be underlined that there is no definition of homogeneity in the EBA paper. It is important to have a clear definition in order to achieve homogeneity (the same issue is underlined further concerning LGD).

Q9

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

The reference to « recovery policies » would lead to very burdensome IT developments, which could make not possible the compliance on time with the new rules.

General comment on paragraph 90:

Multiple defaults would be treated differently for PD and LGD. This would have two main consequences: i) it would be redundant as regard the default probation period; ii) the data collection and management would become significantly complex.

Q10

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?

General comment on paragraph 113:
The proposed formula for the calculation of Economic Loss seems not relevant for operations quitting the status of default.
Ex: in the case of 3 unpaid month instalments, that are repaid in the following month.

- ⇨ Observed recuperation would equal 0
- ⇨ Economic loss would equal EAD at the date of entry in default (if no fees)
- ⇨ LGD would equal 100% whereas there is eventually no loss.

Q11

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?

The 5% add on seems largely disproportioned.

We wonder how would the proposed discount rate (Euribor 1 year + 5%) be consistent with the one described in the new definition of default for distressed restructuring (discount based on the original effective interest rate)?

This proposal would introduce variability since following generations of LGD would no longer rely on homogeneous method of calculation.
The methodology updating rules should be cleary stated in order to avoid instability of LGD. For ex. Euribor 1year should be used at the time of orgination or entry into default and not as of today.

General comment on paragraphs 123-127:
In some credit activities, for example consumer credit activity, there is often no “direct and indirect costs”: costs are considered as global costs. Consumer credit is a retail activity; it is not possible to affect direct costs on each facility.
More generally, the inclusion of management costs in the calculation of Loss Given default is a concern. It seems difficult to affect management cost before the default occurs.

Q12

6.4: Do you agree with the proposed approach with regard to the specification of historical observation period for LGD estimation?

It would be difficult for institutions to determine the « sufficiently broad sample » of closed defaults (in absolute and relative terms) that the proposal suggests to take into account in the calculation of the average long run LGD.
We would wish the final Guidelines to be more precise on the required samples to be used by institutions.

As a matter of methodological consistency with probability of default, institutions should have the possibility to adjust the historical observation period based on the criteria described in explanatory box related to question 5.3 (sustained tightening of underwriting standards, changed relevant legislation, changed business environment, mergers & acquisitions and changes of internal processe, etc.).

Q13…et 14

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

We consider that the proposed treatment could eventually lead to a bias in the result of the long-run average LGD per exposure classes.
More precision is required on how to build homogenous loss classes without taking into account the estimation of incomplete recovery processes.
The proposed treatment would not be representative of the portfolio. The proportion of uncured defaults would be lower in the modelling database than in the global portfolio. It would then be difficult to make corrections in order to get a result that is representative of the global portfolio.
Globally the proposed treatment is too conservative. The treatment of incomplete recovery processes introducing a maximum recovery delay seems not adequate. Delays are sometimes only due to resistance by the debtors in the processes of recovery. Not to recognise the expected amounts to be recovered in those situations would be too conservative.

Q15

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

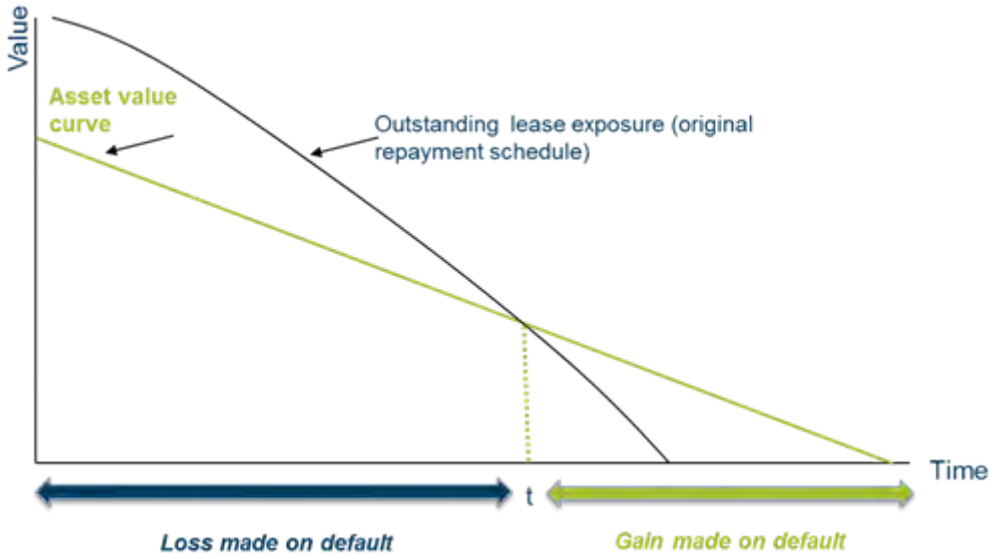
General comments:

- **Exposures secured by durable goods should be recognised as collateral**

We strongly advocate for the recognition of exposures secured by durable goods (e.g. equipment leases and motor finance) as physical collateral for credit risk mitigation purposes because the assets on which the lending is secured exist in liquid markets with transparent and publicly available pricing and can be realised quickly.

- **Treatment of cases with no loss or positive outcome (Paragraph 139)**

The current legislation requires that the estimated LGD used to calculate capital requirements must not be less than zero, which makes sense for modelling purposes. However, the EBA proposal to extend this floor to individual realised LGDs, is not justified in our opinion and would arbitrarily raise LGDs for types of lending which are generally low risk, such as leasing. In fact, the EBA recognises this potentially significant impact to leasing portfolios in the consultation on page 113. Elimination of netting effects does not seem to be a justifiable goal in and of itself, if that netting is in fact reflecting real outcomes. Lease payments are based on the valuation curve of the underlying asset and are systematically designed to result in a potential gain on defaults towards the end of the contract (please refer to the graph below illustrating this). Therefore the EBA proposal would artificially raise capital requirements for leasing portfolios in particular, which are an inherently low risk form of lending.



We would therefore recommend that the EBA remove the proposed paragraph 139 from the final guidelines. We are aware that some Member States have already been applying this rule, going beyond the current requirements of the CRR. If the EBA wishes to promote further harmonisation, we would suggest it be clarified that the current rule on applying a zero floor to estimated LGD for capital requirements does not extend to the individual exposure level, for the reasons already outlined.

Q16

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 (reference Data set) after the final sale of the repossessed collateral?

No comment

Q17

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?

Adjusted comments could only be provided on the basis of a draft RTS on this topic.

Yet, additional elements are indeed necessary to clarify the notion of dowturn.

Moreover, attention should be paid on the articulation between margin of conservatism and downturn adjustment at least in 2 ways:

- some margin of conservatism related to representativeness of data already include downturn elements, so entities should have the possibility to consider and present MoC and downturn adjustement as a whole in order to avoid redundancy;

- historical data shows that Some specific portfolio may be not sensitive to risk drivers, therefore entities should have the possibility not to put any downturn adjustment on theses portfolio.

Q18

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?

Concerning the consistency of LGD in-default and LGD for non-defaulted exposures, it would be necessary to get daily information on the behavior of the customer to avoid cliff effect.
Most specialized credit institutions (consumer credit, leasing, guarantees…) do not manage current bank accounts, and so, do not have access to precise customer behavior information. Models for LGD for non-defaulted exposures would be less precise than the models for LGD in-default, and then could lead to cliff-effects.
Consequently, it would not be consistent to apply the same risk drivers for defaulted/non-defaulted status. Then we have to accept that there are differences between defaulted and non-defaulted status.

General comment on paragraph 161:
For those specialized credit institutions that do not have direct access to current bank accounts, or even to the credit management (residential guarantees institutions), it is not possible to anticipate LGD upward movements before defaults occur.

Q19

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?

The possibility to adopt fixed reference date may lead to inconsistencies in cases of changes of recovery processes or exceptional events. Rather than reference date, a statistical approach based on clustering analysing in order to identifiy proper segmentation by time into default should be preferred.

Q20

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?

No comment

Q21

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

As an example, some consumer credit institutions currently use a short-term average approach.

For some others, at the time of parameters update analyses are made in order to assess if vintages included in parameter calculation are representative of current situation, and depending on the outcome of the analyses adjustments on the historical timeframe may be performed.

Q22

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

As an example, some consumer credit institutions currently use SCRA as ELBE estimate.

For some others, specific credit risk adjustment is not used so far as ELBE estimate but could be used in the context of IFRS 9, in which a higher convergence between Basel 2 and provisioning methodology should be achieved.

Q23

8.1: Do you see operational issues with respect to the proposed requirements for additional conservatism in the application of risk parameter estimates?

Margin of conservatism are already applied; therefore, it should be stated that these margin of conservatism should be included in the existing framework.

Moreover, the proposed approach with a very granular and analytic vision on margin of conservatism may lead to the aggregation of numerous margin of conservatism that would have a significant impact in capital requirement, and most of all will put in question the value of operationality of risk parameter.

Therefore, in order to avoid duplicates, entities should have the possibility to some extent to assess and apply margin of conservatism in a global way, or even not to apply any margin if it can be demonstrated that the deficiency itself lead to a conservative outcome.

Q24

9.1: Do you agree with the proposed principles for the annual review of risk parameters?

No comment

Q25

10.1: Do you agree with the clarifications proposed in the guidelines with regard to the calculation of IRB shortfall or excess?

No comment

Q26

11.1: How material would be in your view the impact of the proposed guidelines on your rating systems? How many of your models do you expect to require material changes that will have to be approved by the competent authority?

For most specialized credit institutions, the impacts on current models would be very material. Due to the proposed Guidelines, they would have to modify consistently their methodology and so, to change all their models (For example currently for one consumer credit institution: 7 models of PD and 7 models of LGD). The costs of complying with these Guidelines will be very heavy, especially on IT systems.

The significant evolution of the institutions models would require numerous validation processes by the regulator.
The most impacting part of the proposal would probably be the LGD estimation (in default and non -default), since it implies the collection of new statistical series of data and the building of new models. Above the main points of operational cost on IT systems, it raises the issue of planning and complying with the deadlines, considering implementation and validation delays.

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