Svenska Bankföreningen
Swedish Bankers' Association

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

General

We welcome the initiative by the EBA to propose a rational and well-motivated model which recognises the need for maintained risk diversification in IRB models. It is important for the future of the IRB approach that it remains institution specific and allows institutions to develop, validate and apply their own models based on their own empirical data.

In general, and specifically relating to how the downturn is determined, however, the institution specific models and parameters are often overridden and affected by adjustments from local competent authorities in the model processes or in the SREP process. Therefore, harmonisation is dependent on risk perception, interpretation and preferences made by local competent authorities in this respect. When developing and applying these new improved concepts it is assumed that the supervisory practices are changed accordingly.

The CRR requirement that institutions should use LGD and conversion factor estimates that are appropriate for an economic downturn if those are more conservative than the respective long-run average, may however be challenging. These challenges relate, among other things, to correlations between internal model components with overall geographic or country specific macroeconomic indicators. Institutions do also have different risk profiles, which will imply different applications.

Correlations to economic indicators may as well have a variable time-lag compared to the economic cycles. Thus, common indicators are likely to first be reflected in balance sheet changes before they have an effect on loss data, and consequently the model parameters. The effect on banks' parameters will be different due to difference in modelling, thus the effect on the RWA will differ.

It is assumed that banks will need time to develop and gain experience from modelling based on references to economic indicators.

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Model specific

Model component approach

The proposed model component approach provides a structured methodology to account for economic downturn when downturn years are not included in the institution's internal data. However, it will be a challenge to link model components to economic factors. One reason for this is that the variation in the LGD can be quite high between different years, even though economic conditions do not change that much. This can result in a spurious correlation between model components and economic factors, even though no relationship exists. A possibility is also that the analysis shows no relationship, but there is in fact a connection. This is probably an even bigger issue for CCF than for LGD.

In circumstances where it is not possible to find a downturn add-on with the model component approach, the institution has to rely on a panel of experts. There is a risk of decreased harmonisation in this situation due to a higher degree of subjective assessment as in regards to the adjustments and MoC.

Finally, we seek further guidance in the RTS on how to identify which downturn years that can be assumed to belong to the same scenario. Is "non-simultaneous downturn periods for different model components" always to be interpreted as concurrent years in the course of grouping down-turn periods to the same scenario?

Reference value approach

The Swedish Bankers' Association prefers the reference value approach.

The reference value approach should prove less cumbersome for institutions to fulfil requirements compared to the model component approach, as well as providing more flexibility. Moreover, a reference value in effect puts a floor, which limits how low the downturn add-on can be. This will on the one hand aid in harmonisation, but on the other hand also limit the risk diversification – striking the correct balance will be important.

A high reference value could be a result of idiosyncratic factors rather than an economic downturn. Take for example the case with a defaulted customer with many exposures, which could result in a high reference value if the loss for that customer is high while at the same time the number of total exposures in the LGD-pool is low. There is a risk that the reference value can be non-representative in these situations. It is written in the guideline that the institution can justify that a reference value is not linked to an economic downturn, but this is not always straightforward to argue towards the supervisory authorities.

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