
Consultation response

Draft EBA RTS on the Specification of an Economic Downturn

25 May 2017

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to respond to the EBA's consultation on the **draft RTS on the specification of the nature, severity and duration of an economic downturn in accordance with Articles 181(3)(a) and 182(4)(a) of Regulation (EU) No 575/2013**

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

AFME very much welcomes the EBA's efforts to harmonise the IRB framework by defining the nature, severity and duration of an economic downturn. We recognise the complexity of such an exercise, particularly as there are likely to be diverging points of view on this technical issue, both within the regulatory community and industry.

Nevertheless, we wish to stress that the importance of the choices that will be made with respect to downturn LGDs:

- The way downturn LGD will be defined has a linear impact on the level of banks' RWAs as LGD is a multiplying coefficient of RWA;
- There will be knock-on effects on the starting point for modelling forward-looking LGDs and therefore on the level of banks' provisions.

Therefore, while the issues raised in this consultation are of a technical and granular nature, the impacts of the outcome could be significant and should not be underestimated.

Moreover, the technical debate should also, to the extent possible, factor in (or not contradict) the Basel Committee's expectations for greater model simplicity. Finally, the definition of downturn estimation methodologies must reflect the specificities of models applicable to critical portfolios such as banks, sovereigns and specialised lending exposures.

General views on the cost/benefit of the model components approach

Our members have concerns about the complexity of the model components approach and the fact that it may well lead to an excessively conservative quantification of downturns, resulting in potentially significant impacts on RWAs and capital requirements. This is particularly worrisome when considered in combination with the expected overlapping impacts of the proposed EBA Guidelines for Margins of Conservatism. We would therefore welcome additional impact analysis across these various pieces of the IRB repair programme before conclusions are made and would ask that the EBA pay attention to ensuring that this complex approach does not overshadow the benefits of LGD modelling or that it unintentionally new "undue" RWA variability.

- We note that banks are required to carry out quantitative and/or qualitative analysis of the relationship between risk parameters and economic factors in several areas:
 - For stress-testing purposes (which will feed the SREP framework)
 - For determining downturn estimation of risk parameters, where overall harmonisation of risk quantification is still in process (EBA IRB repair program / TRIM)
 - For forward-looking estimation to determine expected credit losses (IFRS 9)

Banks are therefore confronted with several similar exercises in order to fulfil various regulatory requirements. We would encourage the EBA and the supervisory community to ensure that the supervisory approaches taken to the above are as coordinated and streamlined as possible to keep implementation burdens across the piece at a minimum.

- The model component approach requires that the worst level observed for a model component is selected and applied, taking each exposure category into account separately. This implies that LGDs, CFs and RWAs are likely to be overstated, and thus disconnected from reality (loss of risks sensitivity). Consideration of each exposure type separately also means that diversification and portfolio effects will not be taken into account. As such, the model component approach may well imply levels of unexpected losses higher than any possible losses. This does not lead to an improved regulatory framework but rather a biased assessment of regulatory capital.
- This being said, and putting aside the burdens of the approach and efforts required from the panel of economists and model experts, conducting quantitative and qualitative studies to analyse correlation between model components and economic factors can be useful and relevant in some cases. However, given that the choice of the final downturn scenario in the draft RTS is based on the most conservative choice (highest LGD), this effectively overrides efforts made to identify the most *relevant* economic factors in the first place.
- Moreover, considering the worst period of each economic factor could hide natural offsetting effects that may exist among model components, thus further contributing to the overstating of losses.
- Complexity also occurs in the model estimation approach through its required maintenance in the model lifecycle process. This is because downturn estimation is an inherent part of the IRB framework, requiring backtesting and, when required, recalibrations, with the necessary model change notifications to and approvals from supervisors.
- Additionally, it is unclear whether joint impact analysis of all identified economic factors should be assessed through a panel of economists (included in the panel of experts), bringing further effort developing the model component approach, especially if the final choice is a de facto a conservative choice. Appropriate estimation does not mean conservative estimation. Conservatism should be introduced into risk parameters only by margins of conservatism (MoC).

- Finally, the model components approach is clearly not adapted to specific portfolios such as low default portfolios: especially for specialised lending, banks/financial institutions and sovereign exposure. LGD models for these types of portfolios tend to be expert-based or result from a combination of statistical models and expert judgement.

Concerns regarding the identification of the severity of an economic downturn

- Economic downturns are likely to be structurally different, exhibiting different levels of severity, and there is no guarantee that they will reflect the structure of the next downturn. Structurally different downturns are likely to exhibit different levels of severity.
- The draft RTS requires institutions to consider a plausible variability in economic factors for the future. In spite this not being the objective of the RTS, this is akin to stress testing; downturn estimation and stressed estimation should not be confused. In the former, the historical behavior of risk parameters observed during a past crisis is replicated to determine the downturn estimation. For stressed estimations, risk parameters are forecasted according to various scenarios specifically designed for forecasting purposes. Forecasts under adverse scenarios (considered to be less likely to occur) are then compared against those of the baseline scenario (most likely to occur) in order to assess the severity of stressed conditions in relation to the plausible evolution of the economy. It should be ensured that the final RTS does not confuse elements of the two approaches when defining downturn methodologies. We do note however that stress testing is likely to be a tool used by experts to inform their judgement in assessing the appropriateness of the severity.
- With respect to the required minimum period of 20 years for historical values:
 - Structural breaks will occur in the time series of economic factors over the years
 - It is unlikely that 20 years for historical values for model components will be available (e.g. across all entities/portfolios of a group). Moreover, the definition of default will not be homogenous during such a reference period.
 - Moreover, 20 years may not always be sufficient to cover 2 economic downturns. We suggest that if data starts from 2007-8 crisis, this should be considered sufficient.?
- The proposal focuses on economic effects and ignores business effects. Internal variables may be more predictive than external economic variables. The proposal assumes the converse. A focus on historic economic data ignores changes in business strategies which impact risk appetite and hence appropriate downturn values. As a consequence, maximum loss may not be driven (entirely) by external variables and maximum loss may not occur when economic variables are at their worst.
- Therefore, we would welcome greater guidance on how to determine the 'representativeness' of data and how and what adjustments may be allowed based on statistical analysis or expert judgement in order to ensure that the historic data is relevant for today's business.

Dependency analysis

- The relation between the identification of model components and the multimodal distribution of realised LGDs or drawings is unclear: we would welcome further explanations of the rationale behind this link.
- The expected level of granularity at which the dependency analysis of economic factors at model component level is required needs to be better defined. In our view, only those model components which are major contributors to the distribution shape should be assessed to avoid undue implementation costs/complexity
- We would recommend simplifying the approach to assessing the EBA list of specific economic factors for each exposure type. In some cases the economic factors may not be relevant. Moreover, the characteristics of each exposure type may already be reflected in the general economic factor (for example pre and post-default prices), therefore the additional dependency analysis may not add anything meaningful. To ensure the framework is not unduly burdensome, we recommend that the EBA list of specific factors is indicative and firms should be able to justify where any factors have not been analysed.

Panel of experts

- More flexibility should be given regarding the panel of experts as this is likely to be extremely time consuming/burdensome for institutions: for instance, if it can be demonstrated that discussions on the characteristics and design of the models with model users and / or model owners already take place elsewhere, the role of the panel of expert might be redundant. It may also be difficult in practice to find experts who have the require knowledge but are independent from the modelling unit.
- Also, it seems unclear whether joint impact should be assessed with a panel of economists (included in the panel of experts), bringing further effort into developing the model component approach, especially if the final choice is a de facto always going to be a conservative choice (cost/benefit).

Downturn duration

- We consider that restricting the duration of the severity to 1 year is extremely conservative since the draft RTS specifies that the worst year in each model component has to be chosen.
- Moreover, making the de facto choice of the worst value of the economic factor is contradictory to the use of economic expertise/judgement.
- Overall, we support a one year period as a minimum backstop where institutions should be allowed to apply a longer duration if appropriate.

Views on alternative approaches

- As noted above, our members are generally concerned about the level of complexity/increased workload the models component approach would create, with little perceived additional benefit. We are therefore in favour of considering alternative, simpler approaches. For institutions with internal data, basing the downturn adjustment on the behaviour of realised losses during downturn periods is simpler and most transparent.
- Moreover, more proportionate approaches are required for low default and low data portfolios, simulation-based models (e.g. for specialised lending portfolios) and for portfolios with a short time series of realised recoveries. For banks and sovereign exposures, the default event is more closely linked to global economic conditions compared to other asset classes. Therefore, estimation of LGDs based on historical defaulted data could complexify the downturn estimation.
- While our members are in favour of alternatives (or indeed a combination of alternatives e.g. depending on the type of portfolio/exposure), there has been no consensus on which particular alternative approach should be adopted. We therefore list the advantages and disadvantages of the various options presented in the consultation paper below.

Supervisory add-on: distributional approach

- Some members indicate that this would be a preferable approach to the model components approach as it is based on volatility of historical losses/recoveries and would reflect internal data. It would thus be particularly relevant in cases where no clear economic downturn period is identified or the models component approach would be too burdensome, as long as the volume of defaults does not condition the observed variability.
- However, a clear breakdown would need to be made between downturn estimation and MoC in the volatility of observed recoveries.
- Other members are of the view that this approach may lead to outcomes with a high degree of variability given that it is likely to be highly dependent on supervisory interpretation. These members are also concerned that the approach is too sensitive to idiosyncratic factors.

Supervisory add-on: Downturn discounting rate with fixed add-on

- While some members indicate that this approach may be an adequate alternative to the models component approach when the scarcity of defaults prevent the characterisation of losses during a downturn period (for instance for LDPs), others would welcome clarification of what a downturn discount rate is and the economic rationale behind this approach (and how it links to the choice the EBA will make with respect to the economic loss calculation – see our response to the PD/LGD GLs).

- Some members have significant concerns about the impacts on RWA of this approach and note that is not neutral to the recovery strategy chosen by a firm (e.g. immediate asset sale versus workout processes which may take longer).

Reference value approach

- Some members see merit in the ‘reference value approach’ as it significantly simplifies the identification of the nature of the economic downturn. However, its calibration at European or jurisdictional level would be inappropriate with a one-size-fits-it-all value being detrimental to a risk-sensitive approach. In addition, it must be noted that the BCBS is considering setting parameter floors and these could overlap with the jurisdiction-level reference values.
- Members are therefore more supportive of the reference value being institution-specific (e.g. average LGD for the worst two years). However, we would welcome clarification on the consistency between the SSM and the EBA positions (comparable requirements with Guide for TRIM). Moreover, the reference value should not become a hard floor and the institution should be able to use values different from reference values when these are appropriately justified.
- ELBE estimation requirements set out in EBA/CP/2016/21 (see page 88) require that “the analysis of the relevant economic and credit factors and their dependence with loss rates should follow the general guidance that will be provided by EBA in the context of the RTS specifying the nature, severity and duration of an economic downturn”. If dependency analysis is performed differently for ELBE and downturn LGD in-default, a non-desirable relation between those parameters can appear. This would have to be addressed if the reference value approach is maintained.

AFME contact

Jacqueline Mills, jacqueline.mills@afme.eu

+44 (0)20 3828 2710