Santander Response

EBA CONSULTATION ON DRAFT RTS ON THE SPECIFICATION OF THE NATURE, SEVERITY AND DURATION OF AN ECONOMIC DOWNTURN

Banco Santander, S.A.

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Santander welcomes the EBA consultation paper on “Draft Regulatory Technical Standards on the specification of the nature, severity and duration of an economic downturn” and appreciates the opportunity to provide comments. Particularly, Santander welcomes the EBA’s objective of reducing unjustified variability in capital requirements, ensuring consistency in model outputs with regard to downturn LGD and CF estimation and thus comparability of risk weighted exposure amounts.

Santander has participated in the consultation response from the AFME industry association and in the questionnaire launched by the IIF. However, in this individual response we would like to emphasize some aspects that are of special relevance to Santander.

Key messages

- The EBA preferred approach (the model component approach) and the instructions issued by the EBA result in far more complex methodologies that those already in use. We consider that some of the proposals may be appropriate for portfolios such as mortgages, but applying the same assumptions for unsecured LGDs and CFs would result in a disproportionate amount of additional workload and in addition we do not see clear benefits from applying this approach versus the already existing solutions.

- Whilst we acknowledge the complexity in this area as the topic of this consultation paper has been discussed for many years with the industry with no agreement reached, we understand the merits of pursuing homogenization in the definition of an economic downturn. However, we consider that it is necessary to strike an appropriate balance between the solutions proposed and their complexity and operationalization. In this sense we see the challenge ahead finding a compromise between the model component approach vs. simpler alternative approaches.

- The duration of the severity is restricted to 1 year, which we considered very restrictive since it does not reflect the typical duration of a downturn. In addition the paper specifies that the worst year in each model component has to be selected for modelling, thus increasing the potential over-conservatism of the proposal. When benchmarked with data from different jurisdictions, initial assessment is that the proposed approach could be excessive and could lead to an unjustified increase of the capital requirements. In combination with the Margin of Conservatism proposed in the EBA Guidelines on the application of the IRB approach, the capital impacts could be even more considerable and consequently, further disproportionate. We strongly suggest that thorough impact analysis against current practices has to be completed before conclusions and suggestions can be made. In particular results of applying the proposed methodology should be benchmarked against realised losses observed during periods of economic distress.

- To the greatest extent possible further clarification on most of the concepts used in the document would be much appreciated (such as a specific definition of model component or a definition for “sufficiently severe economic conditions”).

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SPECIFIC COMMENTS ON THE CONSULTATION PAPER

Questions for consultation

Question #1: Do you have any concerns around the workability of the suggested approach (e.g. data availability issues)?

Although a long history of losses has been accumulated across jurisdictions, it is likely that it will not be possible to have 20 years of data available as at 2020. However, we suggest flexibility should be increased on this requirement and consideration should be given to the relative impact of 'missing' data as in some cased 'missing' years reflect information of relatively benign economic periods. Consequently, the need to analyze 20 years of data should be waived if for example entities have data from the 2007-8 crisis onwards; as it is expected that additional retrospective information would have no impact in terms of downturn LGDs.

Operationalizing the approach for some portfolios will entail a significant amount of additional workload, as the model component approach is significantly more complex than current practices for parameters like unsecured LGD and CF.

Question #2: Do you see any significant differences between LGD and CF estimates which should be reflected in the approach used for the economic downturn identification?

Substantial differences exist between the CF and LGD:

- Bimodal distribution is not typical for CF. In fact, many of the CF development sample observations are characterized by a low undrawn value so that EAD is simply modelled as EAD = CF*Drawn. That is, it is assumed that considering undrawn amounts would only lead to the instability of CF and thus an alternative formulation is used. CFs modelled as a multiplier to the drawn are generally close to 100%. In addition, for some facilities the EAD is estimated directly with no CF.

- For the rest of the observations (percentage of use not close to 100%) where EAD is modelled as EAD = Drawn + CF*Undrawn, realized CF do not typically present a bimodal distribution either.

- Santander Group has ample experience of portfolios where it has been demonstrated that credit risk policies followed at each point in time influence the behaviour of CFs much more than macroeconomic factors, so that CFs may even decrease during economic downturns due to tightening of credit limits

- Estimates are generally based on long-run values (without establishing model components). If a downturn period according to macroeconomic variables has been identified, typically the long-run CFs are compared to those obtained from realized defaults in that period. If the latter values are greater, then those are chosen as regulatory CFs.

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- Thus we propose to exclude the estimation of CFs from the models component approach as the over-complexity that this method entails would be of no benefit to the estimates. Basing regulatory CF on long-run realized values is considered the most appropriate approach (subject to the comparison described above).

In addition, we also consider that **substantial differences exist between secured and unsecured LGD**. The estimation of unsecured LGD is fundamentally based on realized values with no distinction of model components. Whilst the classic distinction between 'cure' and 'loss' as final status may be considered, it is hard to imagine why the economic factors should be different for both model components. Furthermore, sensitivity to economic factors is not very pronounced in the case of unsecured LGD.

Our understanding is that the 'model component' approach only resembles some of the techniques used to model secured LGD (mainly retail residential mortgages portfolios).

Question #3: Is the concept of model components sufficiently clear from the RTS? Do you have operational concerns around the proposed model components approach?

Whilst the clarifications in the textbox (page 18 in the consultation document) are very helpful additional details would be welcomed. Some doubts may arise when actually implementing the methodology, for instance:

- Should direct and indirect costs be considered as model components?
- Which could be considered as model components for CFs?
- Considering a mortgages portfolio where finalization status may be diverse (for instance: cure, repossession, voluntary agreement, debt sale, restructuring, etc.), would it be expected that each of the finalization statuses along with their respective probabilities be considered as model components? What is the expected level of granularity in terms of model components?

In all, it is expected an exponential increase of complexity the greater the number of model components are selected.

Question #4: Do you have any concerns about the complexity around the dependency approach proposed for the identification of the nature of an economic downturn? Is it sufficiently operational?

The textbox on page 18 in the consultative document is generally clear. However, our opinion is that:

- The role of the panel of experts should be made more flexible to the extent that if institutions are able to demonstrate that they extensively discuss the characteristics and design of the models with model users and / or model owners, the role of this panel of expert might be redundant.

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- It would be helpful to include potential economic factors for CF as well.

- Further complexity will arise when considering risk drivers according to which each grade might be differently affected by a model component. For instance it may be that low LTV mortgages are affected by different economic factors than high LTV mortgages.

Question #5: Do you agree with the proposed approach for computing the time series of the realised model component referring to the realisation of the model component rather than to the year of default?

Whilst we understand the purpose of the proposal, we consider that it might mask natural offsetting effects of some model components. For instance, the fact of observing greater probabilities of repossession could be associated to observing lower losses given repossession. If after, for instance, a legislative change repossession becomes rarer, the losses given repossession could become relatively greater for the now lower level of repossessed assets. By using the model component approach we might end up selecting high probabilities of repossession (thus lower probabilities of cures) and high LGDs given repossession, when both events would not happen at the same time. Thus it is essential to ensure that modelling these effects do not result in unjustified conservatism by checking the results again realized LGDs, where all model components are referenced to the date of entry in default.

Question #6: Do you envisage any situation where a one year duration is not suitable of capturing the economic downturn at the economic factor level?

We consider that a one-year duration might be excessively restrictive for the estimates as one year does not reflect the typical duration of downturn periods. Our suggestion is to adapt the duration to the length of the economic crises experienced in each jurisdiction and considering as a baseline duration three years.

Question #7: Do you have any concerns about the approach proposed for the identification of the severity of an economic downturn? Is it sufficiently operational?

As discussed in relation to Q5 above, considering the worst period of each economic factor could conceal natural offsetting effects that may exist among model components, thus overstating the level of losses. Contrast against realized LGDs is essential to avoid undue over conservative estimates.

In addition, it is expected that having 20 years for all model components would not be feasible. If institutions can demonstrate that considering additional years to those available in the dataset would not alter the estimates this aspect should be relaxed.

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Question #8: Do you think that more details should be included in Article 2(3) for the purposes of the evaluating whether sufficiently severe conditions are observed in the past?

We consider that the Article is generally clear. In addition, taking into account the overall recession starting in 2008 it is considered that an appropriate range of variability of economic factor will be available for institutions. However, providing examples is welcomed as it can further help ensure the correct understanding of the point.

Question #9: Do you think Article 6 should pin down the steps for the joint impact analysis described in this text box?

Yes, explanatory text in section 6 is fundamental to understand how to operationalize the approach. Hence including additional details in this article is welcomed.

Question #10: Do you have any concern around the proposed approach about the identification of the final downturn scenario?

Our main concern is that the way the downturn scenario is generated may mask natural offsetting effects among model components, thus resulting in over conservative LGD estimates above any observed realized value. Furthermore, combining worst cases of potentially different downturn scenarios into a single scenario may exacerbate this conservatism.

In addition clarification is required of the definition of long-run LGD, i.e., whether it corresponds to the average LGD in the development sample? Or whether additional adjustments should be applied?

Question #11: Do you see any issue with the estimation of the model components for downturn periods which are not in the data base of the institution (e.g. in step 3 the case where the estimation of cure rate for 2001 is performed on the basis of the dependency assessment described in Article 3(2)(e) and (f)?

It is assumed that simple statistical relationships will be acceptable to deal with this aspect. In addition, missing data in the database corresponds to the period prior to the 2007-8 financial crisis so in general it should be irrelevant for downturn purposes.

Question #12: Do you think the same approach for the identification of the final downturn scenario proposed in this text box for LGD could be adopted also for the purpose of downturn CF estimation?

We do not think that the proposed approach is suitable for CFs. According to Santander Group experience the evolution of CFs in many portfolios is fundamentally driven by credit policies, so that credit limit tightening may even reduce realized CF during downturn periods. Hence, it is expected that statistical relationships with economic factors will vary over time according to the specific credit policies applied.

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Question #13: Do you think the draft GLs should describe in more detail the downturn adjustment methodology?

Yes. Adding additional details in the GLs would be welcomed in order to ensure the consistency of these GLs and the RTS.

Question #14: Do you think simpler alternative approaches for downturn adjustment should be considered in the spirit of proportionality?

Yes. In our view, the model component approach does not reflect the reality of institutions in regard to the estimation of CFs and unsecured LGDs, where simpler alternatives are used. The use of the model component approach would significantly increase the workload of institutions with no apparent benefit. Furthermore, establishing appropriate relationships between economic factors and unsecured LGD components and, most of all, CFs may be difficult.

At the same time it is considered that institutions have been collecting enough data in order to explain the behaviour of credit losses with internal data. In general this data covers both downturn and prosperity economic periods. Thus we consider that basing the downturn adjustment on the behaviour of realized losses during downturn periods is simpler and the most transparent approach.

Question #15: What is your view on the alternative approaches? Please provide your rationale?

Our view is that downturn LGDs should be based on the internal loss experience of institutions during periods of economic distress.

In this regard the 'supervisory add-on approach' would be only being relevant to the extent that:

- No clear downturn period is observed.
- The scarcity of defaults prevents the characterization of losses during a downturn period.

In the first case, the 'distributional approach' could be suitable to obtain the add-on as long as the volume of defaults does not condition the observed variability. In the second case the 'downturn discounting rate with fixed add-on' could be an adequate option.

We see some merits in the 'reference value approach' as it significantly simplifies the identification of the nature of the economic downturn. We do not consider that the reference value should be set at EU or jurisdiction level as it would not be related to the respective internal losses experience. In addition, it must be noted that the Basel Committee on Banking Supervision is considering setting parameter floors and these could overlap with the jurisdiction-level reference values.

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Question #16: Which approach are you currently using for estimating downturn LGDs?

Current approach is based on the BCBS Guidance on paragraph 468 of the Basel Accord.

Unsecured downturn LGDs are based on observed realized losses during a downturn period. The downturn period is defined in terms of the behaviour of the fundamental macroeconomic variables (essentially negative GDP growth rates or elevated unemployment rates) and its duration may vary according to the jurisdiction. If no clear downturn period exists, conservative assumptions are taken via the use of downturn add-ons. In addition, downturn LGDs are compared to long-run LGDs (obtained with the whole period available) so that if the latter were greater they would be the basis for the regulatory parameter.

Secured LGDs (affecting mainly residential or commercial mortgages and modelled in a more complex way as typically several model components are identified) are also closely linked to realized losses observed during a downturn period. However special attention is given to the evolution of residential or commercial property prices in order to ensure that downturn LGDs reflect periods where collateral values show signs of distress. If during the downturn period no decrease of collateral prices is observed conservative measures are applied.

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