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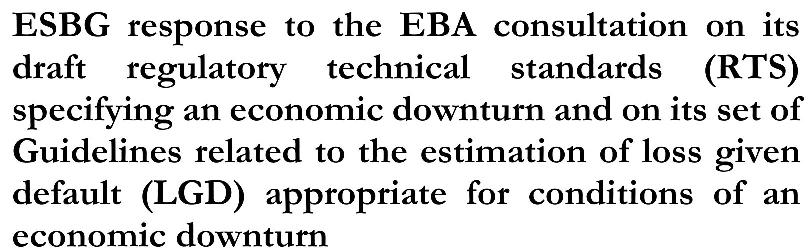

ESBG response to the EBA consultation on its draft regulatory technical standards (RTS) specifying an economic downturn and on its set of Guidelines related to the estimation of loss given default (LGD) appropriate for conditions of an economic downturn

ESBG (European Savings and Retail Banking Group)

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ESBG Transparency Register ID: 8765978796-80

June 2018

Dear Sir/Madam,

Thank you for the opportunity to provide our feedback to the EBA consultation on its draft regulatory technical standards (RTS) specifying an economic downturn and on its set of Guidelines related to the estimation of loss given default (LGD) appropriate for conditions of an economic downturn. We would like to share with you the following reflections that we hope will be taken into account by the EBA.

General remarks

ESBG welcomes the EBA's effort to simplify LGD estimation by making the identification of downturn independently from the LGD estimation methodology. However, we have some serious concerns regarding other proposals. We understand and support the overall purpose to harmonise, but, in our view, the proposals add uncertainty in some areas:

- In ESBG' view, the time frame for introducing the changes is very tight. Both banks and supervisors need time to study the effects of the proposals in order to understand the full extent of the proposed changes. We suggest a quantitative impact study (QIS) to be conducted both at EU level, and in some cases at national level (see our response to question 9 below); contrary to all previous EBA papers as well as previous downturn consultations, paragraph 5 of EBA/CP/2018/01 pulls forward the implementation deadline, with the rules governing downturn phases already set to enter into force on 31 December 2019. As the end of the consultation period is on 22 June 2018, it means that the paper is not expected to be finalised until the end of 2018 at the earliest, so the implementation time for the institutions will be disproportionately short. This applies all the more if institutions do not currently have time series for all the economic factors required in paragraph 2(1) and will therefore have to find external data providers and sign corresponding contracts.

- Our preliminary assessment is that with this setup, a more granular estimation methodology will result in a more conservative approach. This in turn gives a disincentive to differentiate between various sub-segments. We doubt there will be any incentives to differentiate other than between real estate exposures and other exposures, which will make modelling less risk sensitive. We question whether this is the purpose with the proposal;

- For banks which will have to rely on downturn LGD estimation where the observed or estimated impact is not available, the margin of conservatism (MoC) will become a very important aspect. The add-on of 20% to the long term average appears to be very conservative. Furthermore, there is little guidance given on this alternative;

- As ESBG, we are concerned about the fact that the proposal will have very different effects on banks in different member states. The effects will depend on if there is recent experience of a financial crisis or not. For those countries who have recently experienced a crisis, and where banks had internal models in place during that crisis, there will be sufficiently granular data on observed losses qualifying for the definition of economic downturn for banks in these jurisdictions to be able to model according to the first two options in the proposal. These banks then avoid the approach with the MoC add-on. This may mean that banks in countries with no recent crisis may more or less automatically end up having to apply the most conservative alternative in the proposal, resulting in substantially higher risk weights for such banks compared to if these banks would have been allowed to model "properly" as will be the case for banks which have relatively recently experienced a crisis.

- In case of multiple downturn periods, the DT LGD GD establishes on 12.iii "where for several downturn periods LGD estimates are quantified based on the methodologies set out in Section 5 or 6, institutions should choose those LGD estimates relating to the downturn period leading to the

highest average downturn LGD estimate for the considered calibration segment". We consider that this criterion might be misleading since LGDs are strongly influenced by institution's forbearance policies which entangle the effects of an economic downturn. Consequently, this procedure will potentially result in different DT periods identification within entities under the same macroeconomic influence. From our perspective, it would be more appropriate to establish independent criteria from management decisions and incurred losses grounded on empirical macroeconomic evidence (economic factors). This is the case of some ESBG members who have identified two different DT periods: the first in 2008 representing the worst GDP variation and the other, 2012-2013, representing the most severe housing price index variation and the worst unemployment rate variation. According to the guidelines, the first DT period will be chosen as the LGD estimates are higher even though it would have no economic sense since the second period is broadly worse as, in general, all economic indicators are worse.

- Article 2 - Nature of an economic downturn: The RTS aim to harmonise the definition of an economic downturn, for that reason, we encourage the implication of the National Competent Authorities (NCAs) in the definition of the relevant economic factors and even the specific DT periods for a given jurisdiction. This will contribute to a homogeneous model implementation and a reduction of the variability capital requirements for non-risk based reasons.

- Consistent macroeconomic modelling: ESBG considers that given that different models and exercises (e.g. stress test) require a macroeconomic approach it would be appropriate to define a standardised guidance fostering both market and internal practices consistency.

- We do not agree that the duration of the downturn should be extended so that the period covers the troughs in both leading and lagging indicators, as suggested in Article 4(2)(b). Economic indicators can be classified into three categories according to their usual timing in relation to the business cycle: leading indicators, lagging indicators, and coincident indicators. Leading indicators are indicators that usually change before the economy as a whole changes, while lagging indicators usually change after the economy as a whole does. Coincident indicators change at approximately the same time as the whole economy. Taking into account the troughs of both leading, coincident and lagging indicators, as suggested by Article 4(2)(b), the estimated downturn period would be longer than the actual length of the downturn period.

Please find below ESBG's response to the specific questions included in the EBA consultation.

Question 1: Do you think that additional guidance around the estimation of LGD in-default, which reflect downturn conditions, is needed? If yes, could you provide examples of sound methodologies for transposing downturn LGD estimates from performing to non-performing exposures?

Yes, ESBG believes it would be good to include writing similar to the one proposed on LGD in default, i.e. that same downturn component may be utilised to downturn adjust LGD in default estimates.

Additional guidance would also be appreciated on open statements like "sufficiently severe" in Article 3 in DT GD or in paragraph 22 on LGD GD impact analysis (i) elevated realised LGDs; (ii) decreased annual recoveries; (iii) decreased number of facilities returned to non-defaulted status; or (iv) prolonged time in default.

Question 2: Do you share the concern that the proposed policy in paragraph 15 could create an undue burden if applied to every downturn period identified? If yes, in order to better balance the accuracy of the estimations and its operational complexity what evidence should be provided

by institutions in order to justify the exemption of identified downturn periods from the proposed policy in paragraph 15?

In ESBG's view, to reduce the operational burden, a simplified approach would be to compare loss data with the relevant economic factors. If losses do not increase as a result of economic factors indicating a downturn period, even if introducing an appropriate time lag, that should be enough evidence to exempt the identified downturn period from the proposed policy in paragraph 15.

Question 3: Do you agree with the proposed level of downturn LGD estimation set out in paragraph 14? In particular, do you support the concept that the downturn LGD estimates of different calibration segments could be based on different downturn periods? Is the policy on the level of downturn LGD estimation as well as the relation between the level of downturn LGD estimation and the relevant downturn periods sufficiently clear?

ESBG would like to stress that it is not clear on which level downturn conditions should be identified, moreover we believe that this may cause undue variation. In our view, it will be more beneficial from a capital planning point of view to have fewer grades or pools, although from a steering point of view this could potentially drive risk. If estimates shall be based on the worst observed crises, then the more granular you get in estimation the less you may benefit from diversification effects, i.e. the granularity level of estimates may have a significant impact on DT estimates.

Question 4: Do you consider the description of the approaches to be sufficiently clear?

Yes, ESBG considers the description of the approaches to be sufficiently clear.

Question 5: Do you agree to the limitation of approaches for quantification of downturn LGD estimates? If not, which other approaches should be considered? Would you prefer the alternative policy considered – if yes how should a minimum MoC be established in this case?

Yes. However, ESBG sees a potential driver of undue variation in adapting external time series to internal ones. In particular, variations may be significant due to how discounting (5 % add-on) and time in default is accounted for in external data. Therefore, competent authorities have an important responsibility in ensuring there is a level playing field across banks.

Question 6: Do you expect that the total exposure amount or share which is treated with the policy proposed in Section 7 is material?

It is impossible to answer the question as it is unclear when supervisory authorities will find extrapolation methods non-applicable. Given a strict interpretation and reliance on data from 1990s this may be a large share of non-retail portfolios.

Question 7: Do you have specific examples of types of exposures which will fall under the policy proposed in Section 7?

ESBG believes that corporate exposures not secured by real estate may fall within this category.

Question 8: Do you agree to require a minimum MoC quantified via a fixed add-on to the long run average LGD? If not, which of the alternatives should be considered? Do you see reasons for differentiating the fixed add-on according to exposure classes?

ESBG would suggest a QIS to detect possible differences between different exposure classes, type of collaterals and geographical region (i.e. legislation). We think it should not be beneficial to use add-on

but neither should it result in a bank being punished for having to use MoC due to the fact that it has not experienced a crisis during recent years.

It should be noted that lending values as inputs are already geared to the long term. This also applies to other categories of collateral. Of course the 20% should also cover reduced recovery rates and reduced contributions in a recession, but we still think 20% is too high.

Question 9: Do you agree to the minimum MoC as the max (0, min(20%, 105% - LRAVLGD)?

ESBG would suggest a QIS to see if 20% unit add-on is feasible, see Q8.

About ESBG (European Savings and Retail Banking Group)

ESBG represents the locally focused European banking sector, helping savings and retail banks in 20 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 1,000 banks, which together employ 780,000 people driven to innovate at 56,000 outlets. ESBG members have total assets of €6.2 trillion, provide €500 billion in SME loans, and serve 150 million Europeans seeking retail banking services. ESBG members are committed to further unleash the promise of sustainable, responsible 21st century banking.

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Published by ESBG. June 2018.