The Future of the IRB approach

Public hearing on the EBA Discussion Paper

8 April 2015

The problem

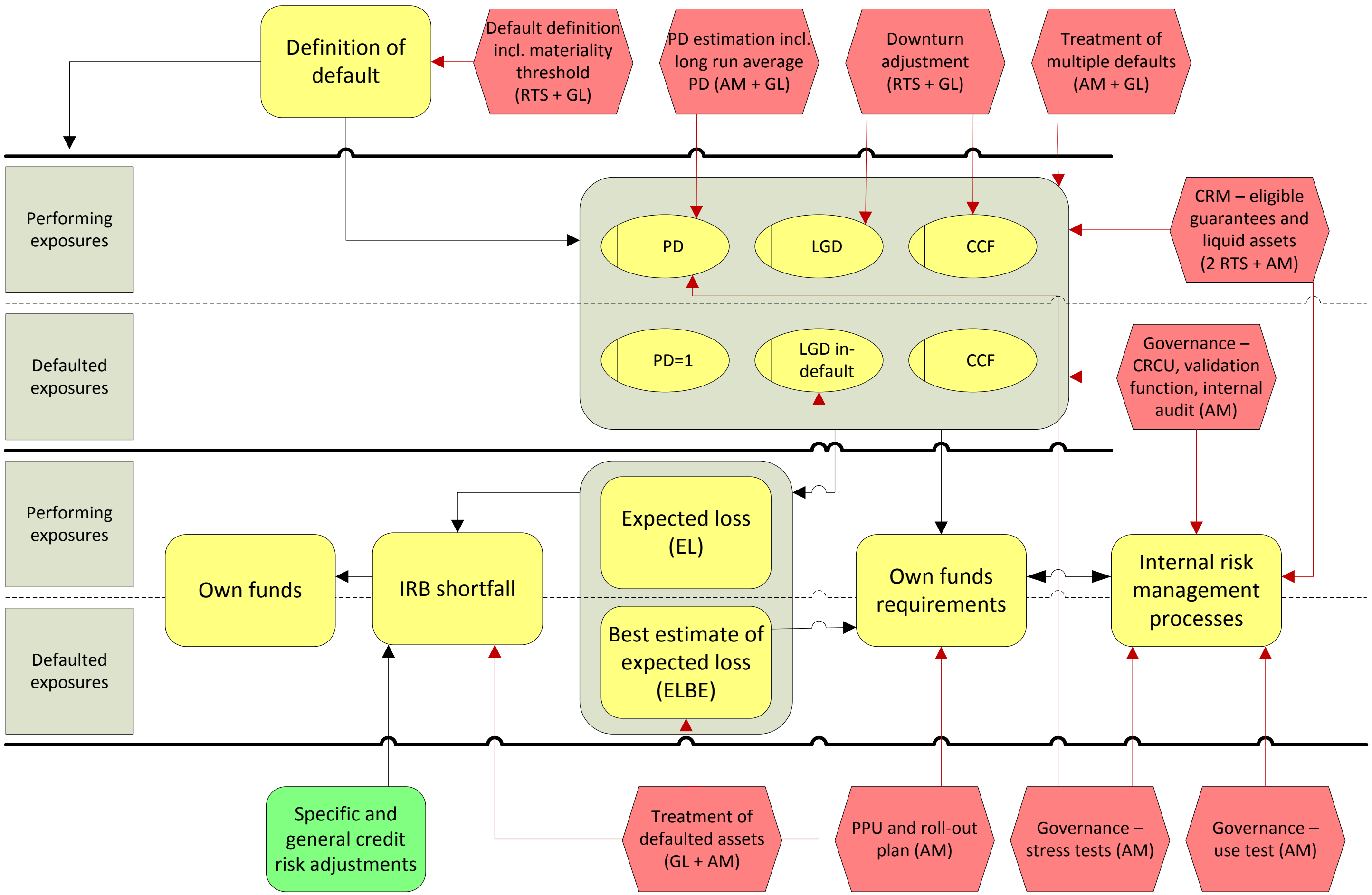
- Lack of trust regarding the use of internal models:
  - High flexibility embedded in the IRB framework - technical model choices lead to substantial different outcomes, capital requirements depend on non-risk based drivers;
  - Concern that models are used to ensure low capital requirements, i.e. regulatory arbitrage, by some institutions;
  - Supervisory practices are divergent.
- All this is well-known, but how to solve it is much more difficult. EBA believes a solution must be based on three strains of work:
  - Regulatory review of the framework (including alignment of definitions);
  - Ensuring supervisory consistency (benchmarking, home-host issues);
  - Increasing transparency (harmonised disclosure).
- This presentation will focus on the first aspect, i.e. the changes to the regulatory framework, as regards IRB models, but the concerns raised are general for all internal models. However, given that around 80% of capital requirements on average stem from credit risk, a revision of IRB models is the natural starting point.

Changes in the EU regulatory framework

Topic	CRR mandates	Other mandates, such as those under Article 502 report
Supervisory practices	RTS under Articles 144(2), 173(3), 180(3b) – on the assessment methodology	
Definition of default	RTS under Article 178(6) – on the materiality threshold	
	GL under Article 178(7) – on the application of the definition of default	
PD estimation		GL on PD computation
Downturn adjustments	RTS under Articles 181(3a), 182(4a) – on the nature, severity and duration of economic downturn	GL on downturn LGD calculation
Treatment of defaulted assets		GL on LGD in-default, ELBE and IRB shortfall calculation
CRM	RTS under Article 194(10) – on liquid assets	
	RTS under Article 183(6) – on the recognition of conditional guarantees	
	RTS under Article 221(9) – use of estimates from IMA for CRM	

Topic	CRR mandates	Other mandates, such as those under Article 502 report
Benchmarking	RTS and ITS under Article 78 – on benchmarking	May lead to further mandates, but none identified currently
	Guidelines under Article 78(6) of CRD – on benchmarking	
Disclosures	GL under Articles 432(1), 432(2) and 433 – on disclosures	May be a need to amend, based on the additional GL and TS under way
		GL on the disclosures on the IRB Approach
Supervisory reporting	Commission Implementing Regulation (EU) No 680/2014 – on supervisory reporting according to the CRR	May be a need to amend, based on the additional GL and TS under way

The IRB model and EBA work



AM – draft RTS on the assessment methodology of the IRB Approach
RTS – draft RTS on specific issues in the defined area
GL – guidelines on specific issues in the defined area

How to implement changes to IRB models?

- The EBA, national authorities and institutions face a substantial implementation burden of the many technical standards and guidelines impacting the IRB models.
- The burden on the industry will be high in terms of implementing the changes and it is likely to lead to structural breaks in the data.
- Changes are likely to be material and expected to put a substantial burden on Competent Authorities when approving the models.
- Hence, a coordinated implementation plan from EBA is needed, that takes into account the burden on institutions and competent authorities.

Other considerations

- The EBA has a substantial amount of well-identified and planned work on its agenda. Delivery will as a minimum require 2 more years of work.
- There has not been significant industry involvement, beyond the consultation processes on the way forward on IRB models:
  - Several industry groups, including IIF has devoted substantial effort to this;
  - The risk-sensitivity of the IRB models is a driving element in their considerations.
- The Basel framework is also being reviewed:
  - EBA is aware of this and coordinate with the Basel Committee to the extent possible;
  - The proposed changes in the EBA work plan is within the existing IRB framework. The Basel framework may be simplified further, but these changes will clarify many of the technical considerations of the IRB framework.

Discussion paper to outline EBA work

- The discussion paper outlines all currently planned EBA deliverables on IRB models and asks for input on the most efficient implementation, taking into account the already substantial work load on the EBA.
- There is a need, as recognised by legislators, to harmonise the institutions' and supervisors' practices. A number of areas requiring further harmonisation has been identified, both in the CRR and in the summary report on comparability published in December 2013.
- **The discussion paper groups the mandates, prioritises the work and proposes a roll-out of the implementation of the mandates.**
- The bundling of the deliverables should enable banks and supervisors to operationally handle the transition. However, other solutions, in particular different bundling and prioritisation of deliverables are possible.

Prioritised grouping proposal

Topic	Priority	Current status	Implementation timeline
Assessment methodology	**1st phase (by end-2015)** – high priority, comprehensive technical standard for competent authorities	RTS on assessment methodology – analysis of consultation responses	For CAs application at entry into force of the RTS
Default definition	**2nd phase (by mid-2016)** – high priority, significant changes highly influencing all internal models	RTS on materiality thresholds – analysis of consultation responses GL on definition of default – under preparation	2.5 years (by end-2018)
Downturn LGD and CCF	**3rd phase (by end-2016)** – medium priority, less significant changes easier to implement	RTS on downturn – under preparation GL – not started	2 years (by end-2018)
PD estimation		GL – not started	
Treatment of defaulted assets		GL – not started	
CRM	**4th phase (by end-2017)** – low priority, only minor changes	RTS on conditional guarantees – not started RTS on liquid assets – temporarily suspended RTS on Internal Models Approach – not started	1 year (by end-2018)

On-going improvement of transparency including disclosure review and supervisory reporting

On-going increase of supervisory convergence, including benchmarking

Future changes to the IRB models

- In addition to these changes, also more substantial changes are being contemplated, both in the EU and internationally. Possible changes to the IRB models, that will require legislative change include:
  - Definition and treatment of LDP portfolios;
  - Change in the application of permanent partial use;
  - Alignment of exposure classes;
  - Change in philosophy of rating models – PIT vs TTC.
- The changes proposed in the first part of the paper will allow a comparison of metrics, whereas the second part of the paper aim at increasing the robustness of the IRB models.
- The implementation of these aspects can take place alongside the changes proposed in the EBA work programme presented earlier.

Preliminary EBA stance

- IRB models are valuable, as they have encouraged banks to develop internal risk management capabilities and provide a risk-sensitive approach that is fitted to the institutions. Hence IRB models should continue to be part of banks capital calculations.
- It is however also clear, that the current generation of IRB models are not comparable. This both goes as regards the data going into the IRB models, but also as regards the calculation methods.
- Hence, comparability is key. This requires:
  - Harmonisation and probably simplification as regards some aspects, i.e. a clearer regulatory framework;
  - Stronger comparability tools, primarily the use of annual standardised benchmarking exercises;
  - Standardised disclosure templates.
- With these improvements, IRB models, should have a sound future ahead.

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