BANKING STAKEHOLDER GROUP

CONSULTATION EBA CP/2016/21
ON GUIDELINES ON PD ESTIMATION, LGD ESTIMATION AND THE TREATMENT OF DEFAULTED EXPOSURES

GENERAL COMMENTS

BY THE EBA BANKING STAKEHOLDER GROUP

[EBA Deadline: 10 February 2017]

London, February 10th, 2017

General comments

Introduction
The EBA has launched a consultation on a guideline regarding PD and LGD estimation as well as the treatment of defaulted exposures in banks internal models. The Banking Stakeholder Group (BSG) considers this a key initiative in enhancing the trust in internal models going forward and therefore welcomes the EBA's initiative.

The BSG generally supports the content of the draft guideline but has a number of more specific suggestions which are outlined below.

Harmonization of internal models
The BSG supports the EBA's view that the existing risk based (IRB) approach to measuring capital requirements has to be an integral part of the regulatory capital framework going forward. The IRB-approach ensures effective levels of capital according to the characteristics of the specific institution and encourages institutions to implement sound internal risk management practices.

However, the BSG also agrees with the EBA that the current flexibility in the IRB-framework has made comparability of capital requirements across institutions and jurisdictions difficult which in turn has created a lack of trust in the use of IRB-models. This is very unfortunate and needs to be addressed.

In order to strengthen the IRB-approach initiatives should focus on enhancing transparency in the credit risk models and harmonizing the use of the models – not limiting the risk based approach in the current regulatory framework by restricting the actual use of the models. Therefore the BSG welcomes further harmonization of how models are developed and calibrated as long as the capital requirement reflects the credit quality and the loan default and loss history of the specific institution. The EBA guideline is a key component in such an approach. In general, the guidelines do not specify in detail all the requirements and definitions. More clarifications would be welcome regarding key concepts in the final version of the guidelines.

Generally, a harmonization of the use of IRB-models should be based on the very important current work taking place in the EBA which is continuously looking at how to enhance comparability of capital requirements and consistent credit risk modelling across institutions and jurisdictions. We support this work and urge the EBA to continue its efforts in this regard.

The proposals of the EBA guideline focus primarily on the modelling of 'high default portfolios'. Some of the concepts proposed cannot be directly applied to 'low default portfolios'. EBA should clarify that this does not imply that proven modelling techniques for 'low default portfolios' are no longer applicable. There should be no indirect frontloading of potential BCBS decisions on 'low default portfolio modelling'.

Increased transparency
Furthermore, the BSG is of the view that increased transparency in relation to the IRB-models will contribute to enhancing trust in the models. This will clarify the differences between the credit risk inside the institutions, since it will be possible to adjust the results for differences between the definitions used and model methods.

A publication of the general model concept from individual institutions in combination with a standardized validation test will make the models more accessible to external parties. This will ensure the correct incentive structure behind the development of the models, i.e. correct statement of risk rather than focus on methods that provide the lowest risk weight. The real risk of the portfolios will be clarified and not obscured by model-specific methods and assumptions.

Finally, an increased harmonization of the internal models as well as enhanced transparency should go hand in hand with strict procedures for authorization and diligent supervision of the use of internal models by the national supervisors as well as the ECB for banks inside the Banking Union.

Specific comments

The BSG has the following specific comments to the EBA draft guideline regarding PD and LGD estimation as well as the treatment of defaulted exposures in banks internal models.

Date of application
The guidelines are proposed to be applied from 1 January 2021. This deadline also applies to the introduction of the harmonized definition of default as published by EBA last year. Although the BSG supports EBA's program to harmonize the fundamentals of using IRB-models it should allow for the proper time to implement and assess the model changes.

First, it will be a tremendous task for the institutions to review the specific IRB-models; either to establish the needed documentation for existing models or to simply build new models. The process of implementing new IRB-models on specific portfolios – including the dialog and approval from competent authorities – typically takes years. Second; with a tight deadline it can be expected that the competent authorities will be heavily burdened with applications of new models to be approved in 2019-20. This does not seem to be a prudent approach given the purpose of improving the trust of IRB-models.

A more prudent approach would be to let the guidelines apply for all applications of new models sent to the competent authorities from a specific date while making a transitional grand fathering of existing approved models allowing the competent authorities and the institutions to plan the process of how and when existing models are transformed to the new standards. This will allow a smooth and sound update of existing models.

Balance between complexity and simplicity of the guideline
BSG acknowledges that in general the proposed guidelines provide adequate guidance for harmonizing PD and LGD estimates. On some of the specific requirements, BSG is convinced that they unnecessarily increase the complexity of the framework and should be simplified. The following are examples of overly complex requirements:

- Requirement of a component covering potential additional unexpected losses in the recovery process. It is unclear what such unexpected losses could be. Unless EBA can show concrete examples this requirement should be dropped to simplify the framework.

- Requirement to develop a methodology for allocating price components to individual collaterals in case of portfolio sales without leading to biased model results. In the case of asset disposals this puts another layer of modelling on top that increases the complexity of the framework.

On the other hand the requirement of using a flat 5% add on for the discounting rate seems to be overly simplistic and lacking a well-founded rationale. This may make the LGD estimates easier to compare on the one side but fails to reflect a necessary differentiation on the other side. In addition, the requirement of quarterly monitoring of default rates is excessively burdensome.

Overall conservativeness of the use of IRB-models
BSG understands that the EBA does not intend to increase the level of capital required but only to harmonize the use of internal models. Having said that it is clear that the harmonization of standards will lead to a change in the capital requirements for some institutions. This is fully accepted by the BSG.

Nevertheless, it seems inevitable that the drafted guidelines will lead to an overall increase in the capital requirements since the drafted guidelines are generally geared towards being more conservative. Examples are the requirements of 'Margins of Conservatism', requirements on discounting, adjustments to the long-run average default rate or conservative assumptions regarding the consideration of incomplete workout processes.

BSG recommends to carefully assessing the overall impact of the drafted guidelines to avoid unintended increases in capital requirements.

The scope of 'Margins of Conservatism'
The BSG acknowledges the need for addressing errors that cannot be rectified or other uncertainties related to the estimation of risk parameters through the 'Margins of Conservatism' (MoC). The BSG also welcomes the recommendation to develop a plan to rectify errors or uncertainties including reviewing the MoC's. However, the BSG thinks that the scope of MoC's should be more clarified.

The BSG agrees that the guidelines should not prescribe any specific method for quantifying MoC. The BSG also agrees that the MoC's should be reviewed on a regular basis by the institutions and any reduction may only be done on a documented basis. However, any overruling by the competent authorities should also only be allowed on a documented basis. It should not be a precondition to make an IRB-model more conservative than a prudent documented assessment says.

On the other hand, the process of refining IRB-models and rectifying data and methodological deficiencies should also be based on a reasonable assessment of the specific parameters. For instance may identified uncertainties in the estimation of a specific parameter be solved by adding an extra new parameter or splitting the one parameter into two or more new parameters. All the new parameters may themselves introduce uncertainties and thus are subject to MoC's. At some point, increasing the complexity of MoC's won't match the benefits of refining the model. In those cases maintaining a prudent MoC of the original specific parameter seems more appropriate.

In general, the interaction between the different parameters and thus parameters with individual MoC's should also be reviewed to ensure that the complexity of MoC's are well documented, i.e. ensuring that a conservative approach on one parameter is not overlapping the conservative approach of another parameter.

Representativeness of data
In line with art. 179.1.d of the CRR ("the population of exposures represented in the data used for estimation […] shall be comparable with those of the institution's exposures and standards; the economic or market conditions that underlie the data shall be relevant to current and foreseeable conditions") and to avoid disincentives to the bad loan disposal, the impact of exceptional NPLs sale on the LGD should be sterilized for a limited period of time (e.g. 2 to 3 years).