

Consultation on Guidelines for the Estimation of PD

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Disclaimer: The views expressed herein are preliminary views, and do not represent final positions on the Consultation Paper



RWA Variance

The IIF RWA Task Force identified the sources of RWA variance in 3 broad categories: some reflect legitimate differences in the national regulatory and governmental framework or in banks' risk profiles, while some warrant harmonization.

NATIONAL FACTORS:

- Local laws: recourse to borrower; consumer protection
- Taxation & Social Security: interest deductibility; safety nets, pensions
- Accounting Rules: days past due; borrowers' key ratios
- National 'Gold-plating': supervisory adjustments, LGD floors, LTV/LVR restrictions

INHERENT DIFFERENCES BETWEEN BANKS:

- Recovery Strategies: sell defaulted exposures in secondary market; hold assets through work-out period
- Managing Deteriorating Credits
- Client-type and Product-type variables
- Portfolio Mix and Segmentation
- Granularity of PD Grades

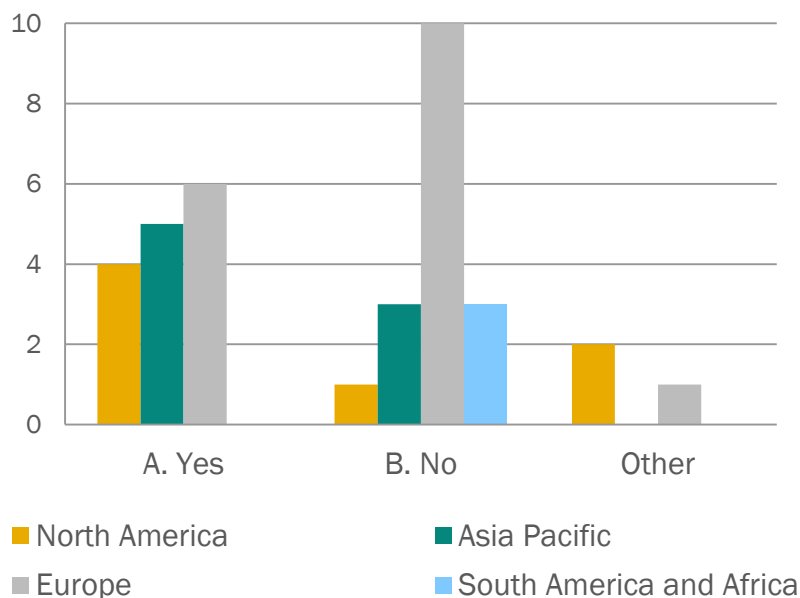
MODELING CHOICES - PARAMETERS & ASSUMPTIONS

- PIT vs. TTC
- Length & Representativeness of Historical Data
- Discount Rate
- Cures and Multiple Defaults
- Unresolved recoveries
- Timing of Data Samples
- Margins of Prudence
- Low Default Portfolios
- Low Data Portfolios

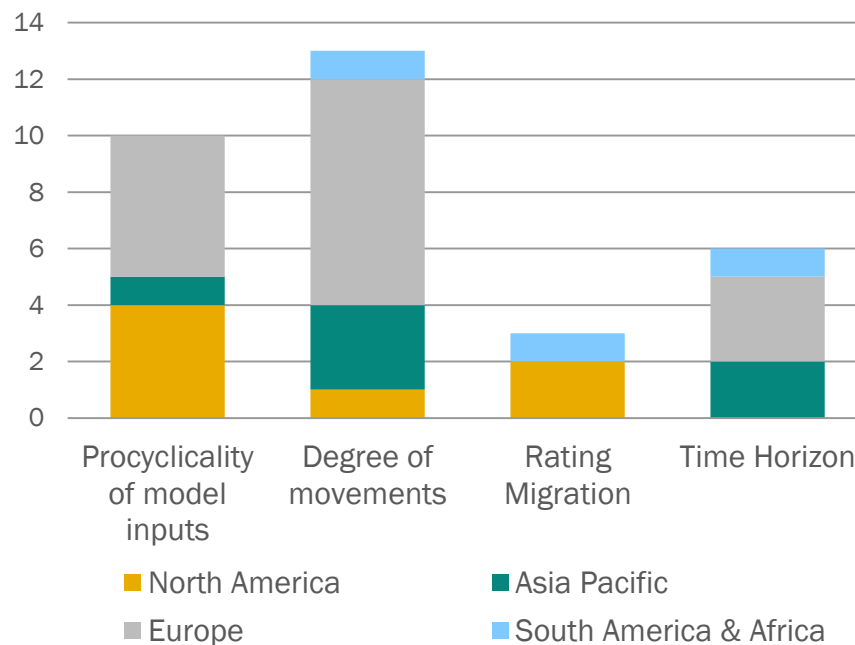
Banks' Approaches to TTC and PIT Definitions

5.4: How do you take economic conditions into account in the design of the your rating system, in particular in terms of:
 a. definition of risk drivers, b. definition of number of grades, c. definition of the long-run average of default rates

Are "Long Run Average" of a 1-yr default rate and TTC PD modeling approach synonymous?



Banks' approaches to TTC and PIT definitions



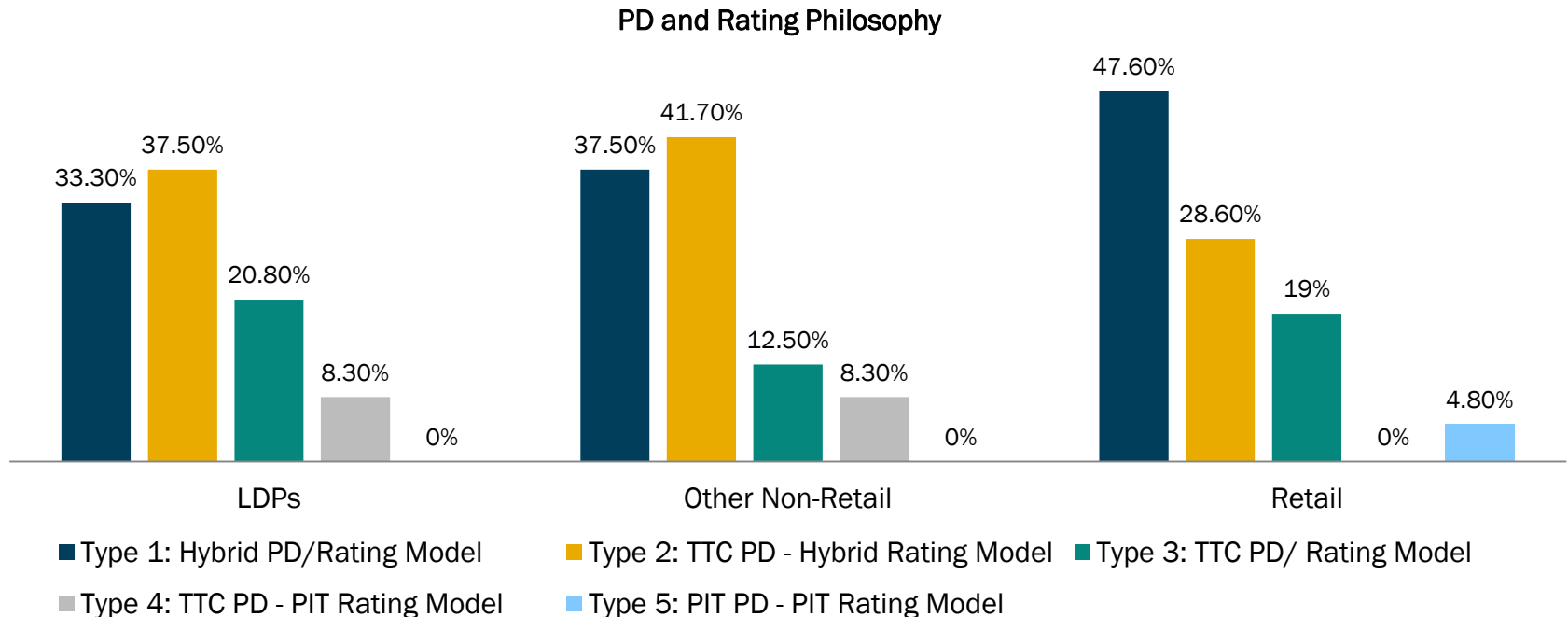
- Most banks agree that TTC PDs reflect a firm's long-term credit risk trend during which cyclic effects have been filtered out.
- At the risk-grade level, TTC PDs exhibit a high degree of stability over the credit cycle and a smoothness of change over time, disturbed only by estimation errors.



PD PIT vs TTC: Approaches to Ratings & PD Models

5.5: Do you have processes in place to monitor the rating philosophy over time? If yes, please describe them.

5.6: Do you have different rating philosophy approaches to different types of exposures? If yes, please describe them.



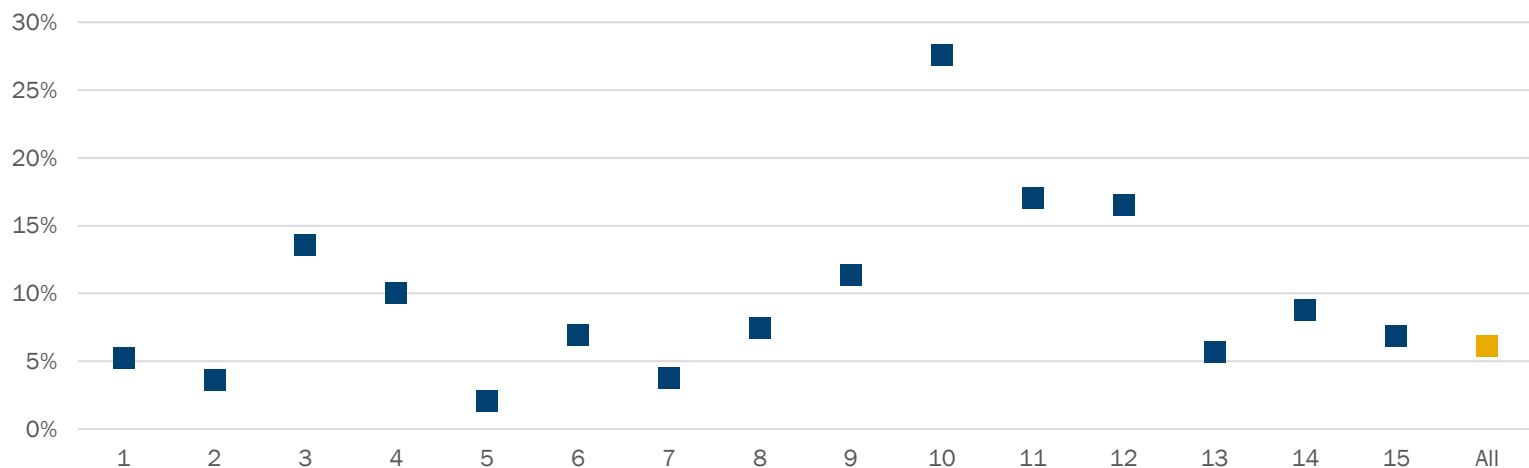
IRTF Final Report:

- 66.7% for LDPs, 62.5% for other non-retail, and 47.6% for retail reported having PDs that are TTC.
- However, 79.2% for LDPs, 87.5% for other non-retail, and 81% for retail portfolios reported having either a hybrid or a PIT rating.

“PiT-ness” of Rating Systems

5.5: Do you have processes in place to monitor the rating philosophy over time? If yes, please describe them

"Average migration drift" per lender



Source: GCD PD/ODF/migrations datapool Summer 2016

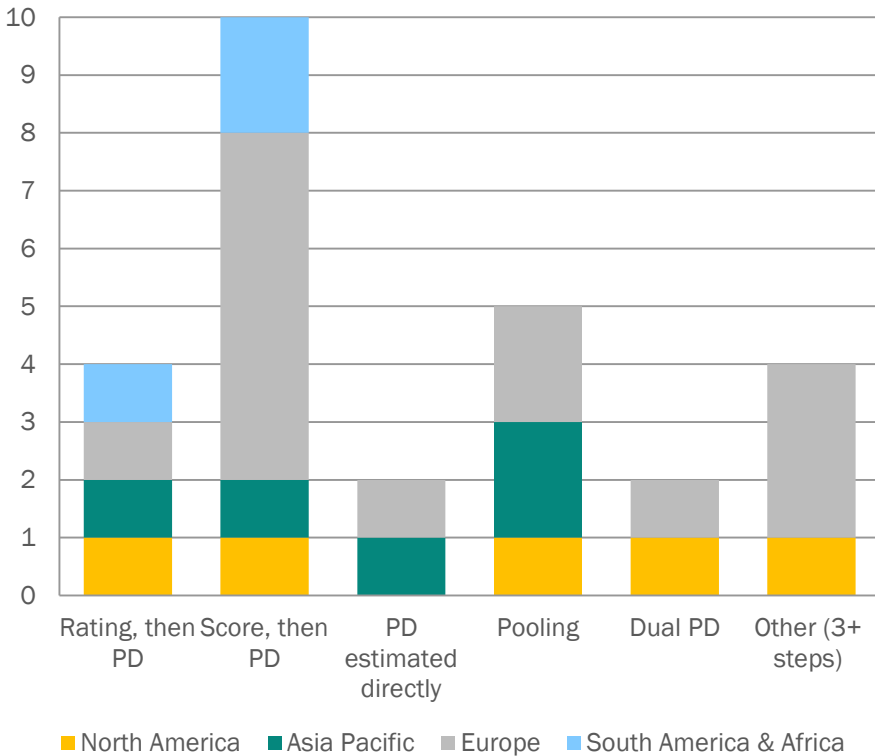
"Average migration drift" defined as $(\# \text{upgrades} - \# \text{downgrades}) / \# \text{borrowers at } t1 \text{ and } t2$

- Banks vary in their rating philosophies, which can be measured by analyzing migration matrices. The higher the “average migration drift”, the higher the “PiT-ness” of the rating system
- However, there is no common way of describing the “PiT-ness” of a rating system

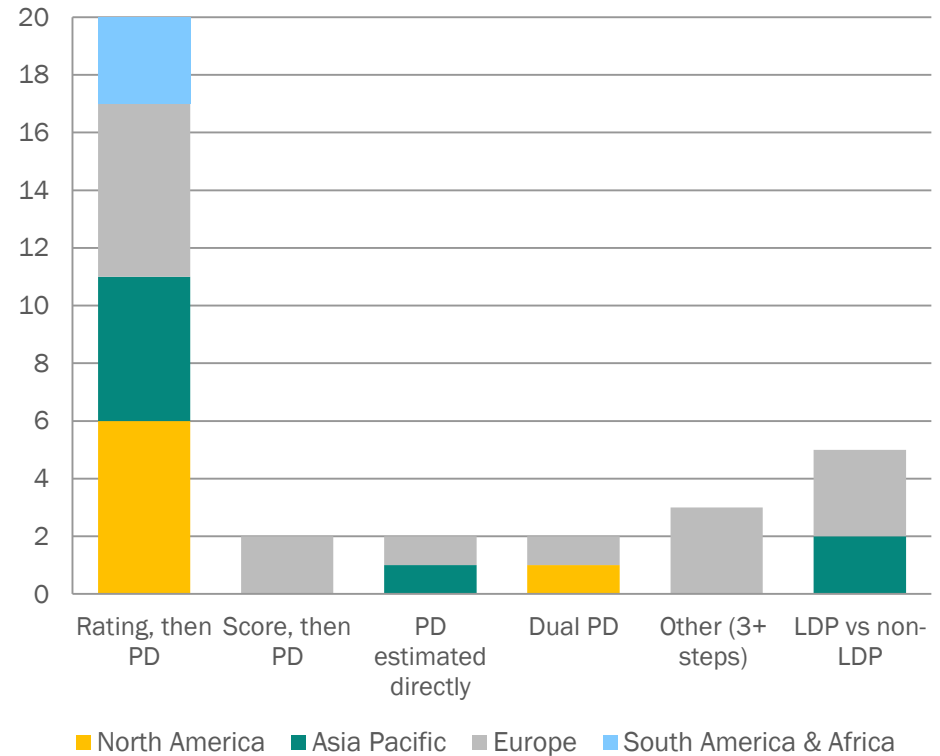
Banks' Methods for PD Estimation

Comments on Sections 5.5.3 Design of grades or pools and 5.5.4 Calibration

Retail



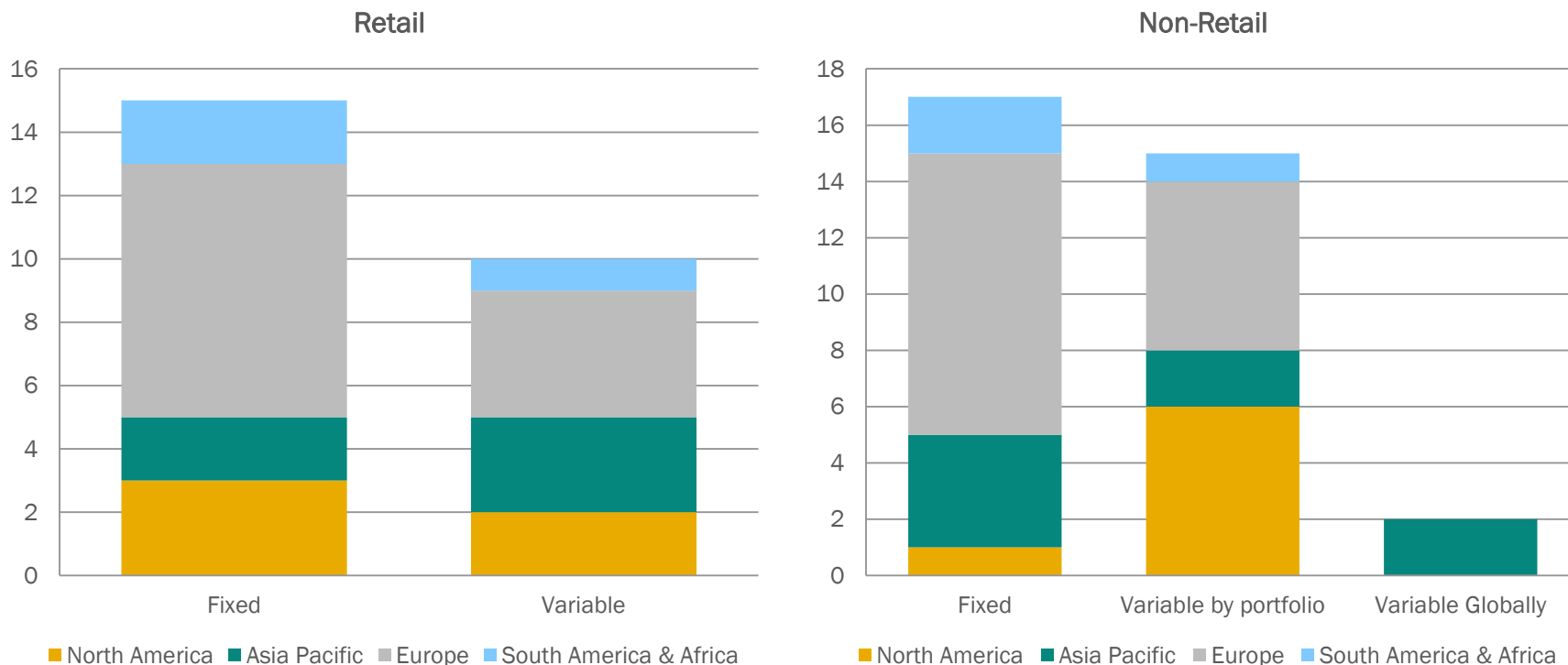
Non-Retail



- An initial (rating) model may perform as a PIT, TTC or hybrid depending on the factors taken into account or forecasted. Clearly discriminating between systemic and idiosyncratic risk at the obligor level is very difficult.

Banks' Approaches to Calibration

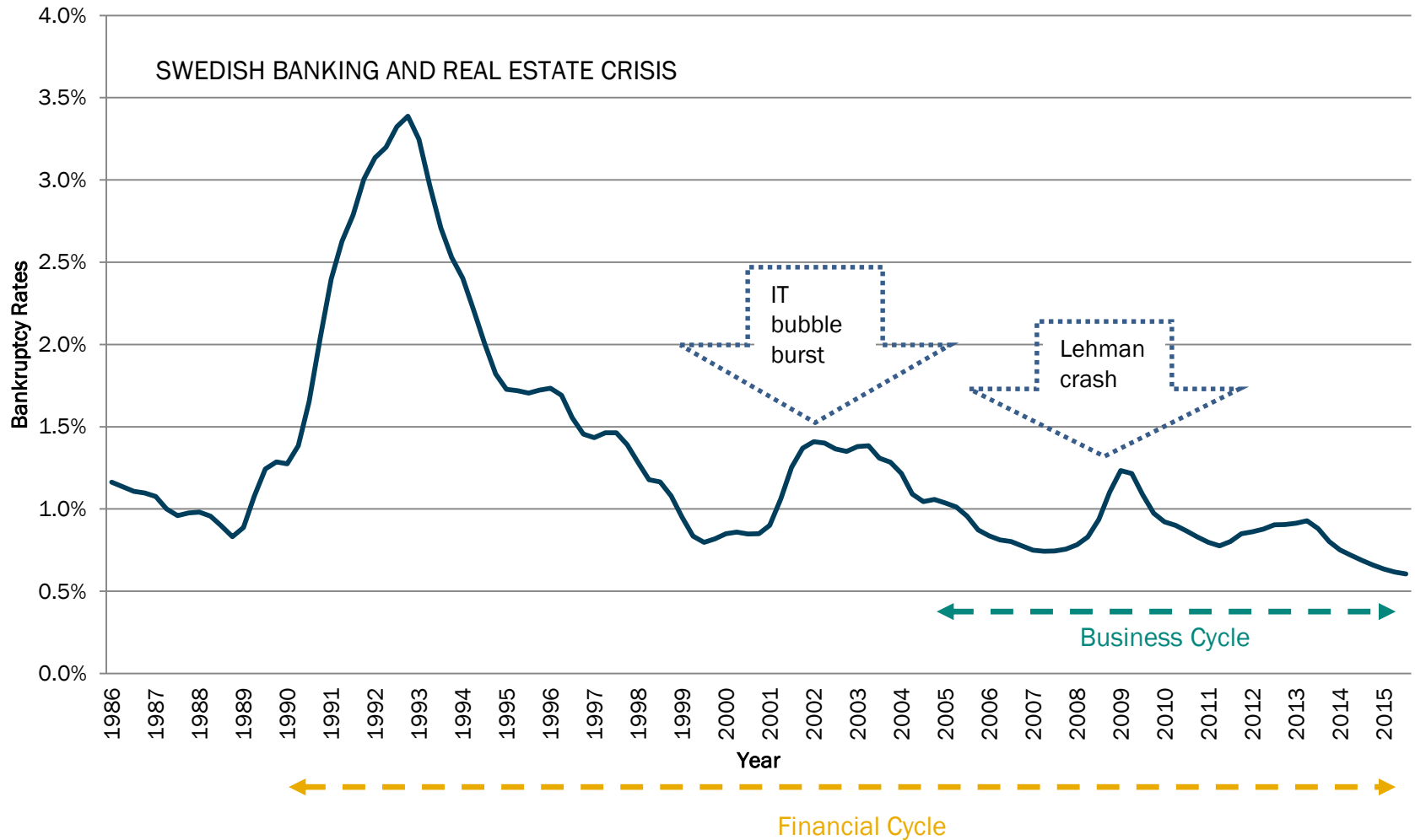
Comments on Sections 5.5.3 Design of grades or pools and 5.5.4 Calibration



IRTF Review PIT and TTC:

- Variable as the rating is assigned “before and irrespective of the PD”. In such a system, calibration changes are made without any impact on the ratings, what changes is the link between a given rating and its PD.
- Fixed as the rating is assigned together with the PD. In such a system, calibration changes impacts the ratings as well (since the link is fixed you cannot change PDs without changing ratings).

Challenges in PD Modelling



Season adjusted bankruptcy rates , 1986-2015
Source: Statistics Sweden

PD Calculations: Other Topics

5.2: Do you agree with the proposed policy for calculating observed average default rates? How do you treat short term contracts in this regard?

Short term contracts

- Currently no special treatment on the regulation, most treat short term contracts as any contracts

Overlapping vs non-overlapping windows

- Recommend non-overlapping windows to facilitate implementation

5.3: Are the requirements on determining the relevant historical observation periods sufficiently clear? Which adjustments (down or up), and due to which reasons, are currently applied to the average of observed default rates in order to estimate the long run average default rate?

Long Run Average Default Rate

- Clarification on requirement for comparison between the adjusted long-run average default rates and the observed average of one year default rates of the most recent 5 years (point 63a)

5.7: Would you expect that benchmarks for number of pools and grades and maximum PD levels (e.g. for exposures that are not sensitive to the economic cycle) could reduce unjustified variability?

- Process would entail benchmarking various masterscales to “one common ground”

