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**BANKING STAKEHOLDER GROUP**

CONSULTATION ON EBA/CP/2014/36 ON  
“DRAFT REGULATORY TECHNICAL STANDARDS  
ON THE SPECIFICATION OF THE ASSESSMENT METHODOLOGY  
FOR COMPETENT AUTHORITIES REGARDING  
COMPLIANCE OF AN INSTITUTION  
WITH THE REQUIREMENTS TO USE THE IRB APPROACH”

# General Comments and Replies to Questions

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BY THE EBA BANKING STAKEHOLDER GROUP

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## Foreword

The EBA Banking Stakeholder Group (“BSG”) welcomes the opportunity to comment on the Consultation Paper 2014/36 CP/2014/36 on “Draft Regulatory Technical Standards on the specification of the assessment methodology for competent authorities regarding compliance of an institution with the requirements to use the IRB Approach in accordance with Articles 144(2), 173(3) and 180(3)(b) of Regulation (EU) No 575/2013”

This response has been prepared on the basis of comments circulated and shared among the BSG members and the BSG’s Technical Working Group on Capital and Risk Analysis.

As in the past, the BSG supports an initiative that aims at harmonizing supervisory rules and practices across Europe, in order to ensure fair conditions of competition between institutions and more efficiency for cross-border groups. The BSG also expects these initiatives to facilitate data sharing between European supervisors and avoid reporting duplications for banks. However, the BSG identifies a number of issues which, unless properly addressed, could lead to unintended results.

This response outlines some general comments by the BSG, as well as our detailed answers to some questions indicated in the CP.

## General comments

The draft Regulatory Technical Standard (“RTS”) illustrated in CP 2014/36 addresses three mandates assigned to the EBA by the Capital Requirements Regulation (“CRR”): the EBA is required to submit draft Technical Standards to the European Commission covering the methodologies that Competent Authorities (“CAs”) must follow when assessing whether an institution complies with

- i) the regulatory requirements for using Internal Ratings-Based (“IRB”) models (Article 144.2);
- ii) the integrity of the assignment process and the regular and independent assessment of risks (Article 173.3);
- iii) the requirements for the estimation of the obligors’ PDs (Article 180.3b).

The above-mentioned methodologies should apply both to first time applicants and to institutions having their internal models significantly updated or periodically reviewed.

Ensuring consistency, transparency and comparability across the banks' internal models has become a priority for supervisors, due the fact that risk weights based on the IRB approach have prompted increasing scepticism among market participants, scholars and rule makers.

Additional ratios based on plain (i.e., un-weighted) assets have been introduced by a number of national authorities and are being finalised internationally. In a similar vein, the risk weights originated by internal models are increasingly being constrained through various "floors" designed for specific portfolios. As far as the latter are concerned, one should mention that the Basel Committee is currently consulting on new floors, which would draw on a significantly revised standardised approach where references to external ratings are complemented/replaced by different indicators<sup>1</sup>. The implications of such innovations look potentially huge, and the risk of unintended consequences is material.

Whilst we believe that "plain" ratios, if carefully engineered and gradually implemented, may help in providing a "backstop" to reduce incentives for some banks to "tweak" their IRB risk-weights, there remains a concrete risk that – in an attempt to curb opportunistic behaviours – external constraints on internal ratings end up weakening their risk sensitivity. This would jeopardise a large part of the improvements achieved – under the Basel II Accord – to endow banks with a consistent, enterprise-wide framework to measure, price and manage credit risk.

Although we understand the desire to apply standardised, simplified and conservative tools to assess bank capital requirements, the scope of application of such standards should be carefully evaluated. Internal models are intrinsically aimed at assessing the creditworthiness of customers and assisting in the pricing of credit risk when originating loans. Simplified standards may give rise to biases that are even more significant than those they are supposed to address, thus distorting credit origination practices and credit markets. This is especially true for markets such as corporate credit in Europe which – unlike in the US where traded securities play a pivotal role – remain focused on bank loans to provide adequate funding flows to non-financial companies.

To avoid such an unwelcome scenario, efforts to improve the accountability and credibility of the banks' internal ratings are urgently required. Ensuring consistency across institutions and national jurisdictions is a crucial part of this process, and the RTS discussed in CP 36 may have a positive and significant impact.

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<sup>1</sup> Basel Committee on Banking Supervision, "Revisions to the standardised approach for credit risk - consultative document", December 2014; Basel Committee on Banking Supervision, "Capital floors: the design of a framework based on standardised approaches - consultative document", December 2014.

The draft RTS includes an introductory section and 13 chapters, covering different profiles and steps of the development/management of an internal ratings system. Some are technical in nature (such as those dealing with data requirements, PD estimation and risk quantification), while others focus mostly on organisational issues (e.g., internal governance, oversight, use and experience test). In the following section we comment in detail on several of these chapters, providing our feedback to the questions outlined in the consultative package.

Overall, we believe that all key areas of IRB/PD validation have been appropriately addressed by CP 36; however, as shown below, some specific requirements that are outlined in the draft RTS should be better clarified, ensuring that the proportionality principle is applied extensively to avoid unnecessary compliance costs for smaller institutions.

Finally, while we understand that the RTS relates to methodologies, as per the mandates assigned to the EBA by the CRR, we also believe that the EBA should make an additional effort to develop tools that can be used to effectively compare validation practices used by national authorities, and to benchmark validation outcomes across banks and jurisdictions. A framework for identifying and challenging outliers could, for example, be developed, based on a comply-or-explain paradigm, so that the validation processes used by local supervisors can be assessed through actual case studies and subjected to peer review. We therefore wholeheartedly support EBA's efforts to stimulate a public discussion on its preliminary proposals to improve the IRB regulatory framework<sup>2</sup>, hoping that such proposals will provide a basis for swift action by Competent Authorities in the European Union.

## Replies to Questions

### 1. What views do you have on the nature and appropriateness of the proportionality principle in Article 1(2)?

There are areas in the RTS that require further clarification, as well as definitions that need further elaboration to optimise their impact on the supervisory assessment process. For example, it should be better clarified how the proportionality principle applies for less significant portfolios and entities at solo level.

Furthermore, the reference to “additional methods” should be defined more carefully, to avoid lack of transparency, since the basis for supervisory assessment cannot be understood based on CRR articles alone.

Comprehensive definitions should also be provided concerning a number of additional relevant criteria in the assessment methodology, besides those already

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<sup>2</sup> European Banking Authority, “Discussion Paper – Future of the IRB Approach”, 4 March 2015.

stated in the CRR. This includes, for example, the frequency of the assessment, the level of aggregation, the exact meaning assigned to the concepts of “complexity” and “size”, all of which might differ significantly across member states. Unless such criteria are better specified, there is a risk that the RTS requirements may not be applied uniformly across the European Union.

Finally, an explicit clarification would be helpful, concerning the timeframe required when an institution develops new ratings replacing the ones already in use, indicating whether the three-year minimum mentioned in article 145 also applies to this case.

2. Do you agree with the required independence of the validation function in Article 4(3) and Article 10? How would these requirements influence your validation function and your governance in general?

We agree that the validation function should be separate from the function responsible for originating and renewing exposures. Furthermore, we agree that some degree of independence is also desirable between the personnel involved in model validation and those involved in model development; however, it should be better clarified how deep such separation is expected to be. For instance, when no separate validation unit exists (see Article 10.1.d) the draft RTS requires that the staff performing validation be separate from the remaining staff in the unit responsible for “model design or development” or in the “credit risk control function”. Does this require that, as a rule, the validation function has to be separate from both the credit control function and the staff involved in model development? How does such a proposal align with the provisions of Article 190.2 of the CRR (letters e and f), where it states that the credit risk control function should review “the rating criteria to evaluate if they remain predictive of risk” and perform an “active participation in the design or selection, implementation and validation of models used in the rating process”? This apparently suggests that (at least as long as the model development function is separate) the model validation unit and the credit risk control unit should at least belong to the same office or department. Additionally, Article 190 also seems to indicate that some overlap should still exist between the model development unit and credit risk control unit, even if the two are separate functions.<sup>3</sup>

In defining organisational requirements for model development and validation, one should be aware that considerable amounts of resources are required by such functions as IRB models are initially rolled out. On the other hand, once models have been extended to an adequate portion of an institution’s credit portfolio, the focus of activities can be shifted towards validating model performance and amending existing methodologies. In that second, “mature” phase, a strict separation between model development and validation function makes less sense

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<sup>33</sup> A similar remark applies to Article 10.1 (c) of the draft RTS.

and may prove especially inefficient for small to mid-sized institutions. In that phase, as the ongoing review and validation of the models become core activities for the credit risk control function, it could become more difficult to keep them separate from the remaining tasks of the credit risk control unit.

In more general terms, it may prove difficult for small-to-medium sized banks to perform an effective separation between the staff involved in model validation and the remaining personnel. Model development and validation (as well as some aspects of credit risk control) require very similar skills, and it seems wise to allow a bank (except, possibly, very large ones) to use specialised experts across the two areas. A tight separation would trigger undue costs, especially for smaller institutions, and would make it harder for smaller banks to attract specialised personnel, if they are only allowed to participate in a limited range of activities.

To increase flexibility in the use of human resources, and to improve the consistency of these provisions with the proportionality principle, the RTS may simply require that – in smaller institutions – the staff responsible for the validation of one model be separate from that in charge of the development *of that model*. To increase independence, documentation on model development and validation could be periodically reviewed by independent experts, as well as through internal audit assessments.

The requirements in Art. 4 (3) would lead to considerable difficulties for banks that use joint rating systems developed on the basis of pooled data (pool models). For the participating banks, pool models have numerous advantages: the use of pooled data allows them to develop and use sophisticated rating systems that they would not be able to develop on their own. Especially the discriminatory power and the forecasting quality are significantly enhanced by the use of larger data sets.

In some pool models the participating banks have outsourced the development and the operation of the rating systems to a common central unit. At the same time, this unit also provides a basic validation of the rating systems at the level of the data pool. Thereby it provides a valuable input for the comprehensive validation activities performed by the individual member banks.

As Art. 4 (3) prohibits a third party to be involved in both the model development and the validation coincidentally, this requirement would constitute a severe drawback for the use of pool models. In order to comply with it banks would either have to perform the validation themselves or they would have to establish a separate unit that is responsible for the validation of the rating systems only. Both would be extremely costly if not impossible. Since many of the advantages of these systems depend on the use of a central unit, Art. 4 (3) would challenge the very existence of pool models.

We therefore strongly recommend allowing the involvement of the central unit in the tasks of the validation function of the banks if certain conditions of independence are fulfilled.

3. Are the provisions introduced in Article 49(3) on the calculation of the long-run average of one-year default rates sufficiently clear? Are there aspects which need to be elaborated further?

We consider the provisions introduced in Article 49(3) to be reasonably clear and based on sound methodological practice. However, one aspect that could be clarified is the definition of “observed data” as mentioned in Article 49.3.b (whereby, if a reconstruction method is used, “this method does not lead to a less conservative calculation of long-run average of one-year default rates than those estimated from the *observed data*”). If “observed data” only refers to *internal* data, then such a condition may prove overly demanding. In fact, there are circumstances where reconstruction methods should be allowed to produce a less conservative long-run default rate than the one emerging from internal data only. For example, if internal data are available only for a recession period, and relevant external data is available for a whole economic cycle, then it would be quite logical to allow banks to use an estimate for long-run default rates that falls below the average of internal data. Unless this is recognised, institutions may refrain from rolling out internal ratings for portfolios where internal data would generate (unrealistically) high long-run PDs.

4. Do you agree with the required number of default weighted average LGD calculation method introduced in Article 51(1)(b) and supportive arguments? How will this requirement influence your current LGD calculation method? More generally, what are your views as to balance of arguments for identifying the most appropriate method?

The proposal looks appropriate (and consistent with the approach dictated for PD estimation) for “standard” portfolios where the number of defaults is large enough and EAD concentration risk (granularity risk) is acceptable.

However, banks may also have to estimate LGD for low-default portfolios and/or for portfolios that include a small number of large exposures. An example is the case of highly-rated corporates, which historically have experienced a low number of defaults, and that are often exposed to EAD concentration risk. In such cases, it may be advisable to find ways to take into account the riskiness of each individual exposure. Generally speaking, supervisors should ensure that LGD estimates provide a conservative measure of long-run averages. If that requirement is met, then banks should be permitted to calculate exposure-weighted LGDs if that makes their estimates more reliable.



5. Are the provisions introduced in Article 52 on the treatment of multiple defaults sufficiently clear? Are there aspects which need to be elaborated further?

We regard the provisions provided under Article 52 as appropriate and reasonable. We consider it correct not to provide rigid indications on (or set boundaries to) the length of the “cure period”: in fact, differences in the length of such periods may be justified by national legal frameworks and/or by the institution-specific features of early recovery procedures, without prejudice to the accuracy and reliability of IRB models. The approach chosen by the EBA (to request that institutions explicitly justify their chosen cure periods and ensure that such choice is consistent with empirical default experience and internal policy) seems adequate to mitigate the risk that cure periods are defined in an arbitrary or opportunistic way, e.g. to minimise capital requirements.

6. Are the provisions introduced in Article 60 on the treatment of eligible guarantors for the purpose of own-LGD estimates sufficiently clear? Are there aspects which need to be elaborated further?

We see some benefit in a clarification on how to include the impact from credit mitigation through guarantees into capital requirement calculations. There should not be any doubts about how institutions should treat the impact of guarantees in the models.

7. Do you support the view that costs for institutions arising from the implementation of these draft RTS are expected to be negligible or small? If not, could you please indicate the main sources of costs?

While we appreciate that greater consistency in validation methodologies across the EU will bring about clear benefits in terms of a more level playing field and increased credibility of capital requirements, we would not go as far as to say that the implementation costs of the RTS discussed in CP 36 will always be small or negligible.

In fact, for several institutions implementing some of the requirements set out in this RTS will trigger significant costs, not least the costs associated with changes in the criteria applicable to ongoing approval processes that are already being negotiated with local supervisors. Accordingly, it would be helpful if the RTS could clarify how banks should deal with the interactions between the new rules and the earlier guidelines issued by local Competent Authorities.

Areas where expected costs appear significant include new rules for multiple defaults, as well as rules for PD estimation through a complete economic cycle. Other cost-sensitive issues comprise reconstruction methods for models where the observed data are not representative: in such cases, costs may also arise from higher estimated PDs affecting the viability of business lines that significantly



depend on IRB models, e.g. in terms of loan approval and pricing (and/or lead to a material increase in risk-based regulatory capital).

The impact of the new validation rules on some banks' business models may, to some extent, be exacerbated by the joint introduction of IFRS 9, the new standardised approach that is currently being discussed by the Basel Committee along with the related floors.

Even when the new rules do not lead to significant changes in risk parameters, the costs associated with transforming data and reconstructing models may prove significant.

While we understand that the benefits associated with better model validation, enhanced transparency and greater cross-country uniformity may well offset the costs experienced by most banks, we recommend that every effort be made to minimise unnecessary burdens, especially for small-to-medium sized banks, also through a careful and pragmatic use of the proportionality principle.

#### 8. What are the main benefits for institutions that you expect by the adoption of these draft RTS?

The RTS reduces the scope for subjective interpretations of the regulatory requirements set out by the CRD4 and CRR, and we firmly believe in the benefits associated with increased consistency, greater harmonisation and enhanced accountability of local supervisors, above all if some provisions can be better specified in a way that recognises the difference between large and smaller institutions. We are positive that greater consistency across Competent Authorities, jurisdictions and banks should be swiftly achieved through common rules such as those stated in CP 36. Failing that, the whole Basel 2 framework, based on risk-sensitive requirements and internal models, might be replaced by a system of simplified rules, capital floors and basic indicators that provide no real incentive for banks to develop sophisticated credit risk models.

#### 9. Do you expect that these draft RTS will trigger material changes to the rating systems (subject of the RTS on materiality of model changes)? If yes, could you please indicate the main sources of the changes (please list the relevant Articles of these draft RTS)?

The sources of change are most likely to depend on each bank's internal rating system, as well as on the rules and guidelines followed by local supervisors in the past. Some changes – although material – may be desirable, inasmuch as they amend competitive distortions across EU countries, due to different validation practices.

The true risk, in our view, is that of introducing rules that – in some cases – may prove unnecessarily conservative and burdensome. The criteria on reconstruction

methods and “original data” that were discussed under Question 3, unless appropriately clarified, may provide an example. Similarly, rules on separation among model development and validation – unless they are made reasonably flexible through a careful use of the proportionality principle – may trigger organisational shifts which, while expensive in terms of extra costs and reduced effectiveness, may not deliver the expected benefits.

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Submitted on behalf of the EBA Banking Stakeholder Group

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