

Consultation response

RTS on IRB Assessment Methodology

12 March 2015

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on **the EBA's Consultation Paper on the Draft RTS 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**. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

GENERAL COMMENTS

AFME welcomes the EBA's publication of this draft RTS on IRB Assessment Methodology. We see this RTS as being part of the EBA's ongoing efforts to harmonise EU supervisory practice which, in our view, is paramount to fostering consistent implementation of the CRR and reducing variance in risk weighted asset outcomes due to supervisory divergence.

At the same time, we strongly believe it is essential to keep flexibility in the way models are built and used so that risk parameters are kept as much as possible in line with the economic environment. Indeed, risk parameters are key inputs in the risk management of the bank and need therefore to be constantly adapted. We would like to underline here that an over-restrictive limitation of human judgement would be detrimental to the forward looking aspects of internal rating and could jeopardise the link between the actual perception of the risk and the risk parameter.

We appreciate the challenges the EBA faces in having to simultaneously balance harmonisation and flexibility objectives and hope that the detailed comments we set out below will provide useful input and assistance in achieving these goals.

Before going into our detailed comments on the draft RTS, we would however like to point out that we have had some difficulty in responding to this consultation. Whilst the topics included in the consultation are of high importance to firms operating in the EU, most of the proposals in the document make minor changes to key requirements, particularly as there are other consultations either in progress or forthcoming which deal with the same topics. For example, an EBA consultation on the materiality of defaults has only recently closed¹, and we understand that another EBA consultation on the definition of default will be released shortly. Additionally, these EBA consultations are issued at the same time as international rules continue to evolve². The definition of default is used

¹ <https://www.eba.europa.eu/-/eba-consults-on-materiality-threshold-of-credit-obligation-past-due>

² The Basel Committee announced in November 2014 that it is considering changes to the very same requirements, including, for example, the definition of default

as an illustrative example, but the same point applies to other aspects of the EBA proposals in this consultation, including changes to Loss Given Default (LGD) and the independent validation of models.

It is therefore difficult for industry to simultaneously focus (its limited) resources on all of the moving parts to the framework and to fully understand the implications of overall change. We would therefore encourage the EBA to take a more coordinated approach to the rule making process whenever possible in the future. In this context, we very much welcome the recent publication of the EBA's Discussion Paper on the future of the IRB Approach and look forward to providing our comments on this in due course.

DETAILED COMMENTS

Proportionality

Q1: What views do you have on the nature and appropriateness of the proportionality principle in Article 1(2)?

As currently set out in Article 1 of the draft RTS, the proportionately principle only appears to apply in a one-way fashion, i.e. the individual assessment framework would only ever be more stringent than the requirements detailed in the RTS. To clarify this, it may be more appropriate to refer to "alternative methods" rather than "additional methods" in Article 1(2) when this is warranted by the need to ensure proportionality.

We are also unclear whether materiality and complexity should be the only elements to be taken into account when assessing proportionality. We think that the nature of the activity and risk profile (amongst others) of the exposures in question are also extremely important elements to consider.

Level of application

We understand that the level of application of the IRB assessment methodology will be in line with the scope of application of the CRD. In other words, if a firm applies the requirements at consolidated level and does not have to apply them at solo-level, the IRB assessment will be made at group level. Nevertheless, we think that clarity is still required with respect to how smaller entities of a larger group will be treated when they are required to apply the CRD on a stand-alone basis. In particular, the proportionately principle, and therefore a lighter assessment framework, should apply in cases where these entities are not particularly complex and are focused a single line of business. We also suggest that proportionately be assessed against the absolute size of an individual legal entity, as well as against its relative weight within the wider group.

We also wish to raise a specific scope point on stress testing and PD models. According to Recital 28 of the proposed RTS, "The results of the stress tests should be taken into account in the decision making process in the area of risk and capital management processes. [...] In particular the default rates and rating migrations under stress conditions should be taken into account in the assessment of the adequacy of the calculation of the long-run averages of one-year default rates and the dynamics of rating systems".

We think more clarity should be brought on this significant change to the current modelling of default rates, and especially on how it should be embedded into banks' daily practices. We understand from the EBA public hearing on 9 February 2015 that a consolidated approach would be considered sufficient (i.e. top-down assessment of the adequacy of the calculations of stressed PDs, as opposed to a bottom-up approach where all PDs of all models would have to be stressed individually). We would welcome confirmation of this point in the final RTS as indeed, banks may not necessarily be organised to deal with cycle definition and measurement issues at such granular levels and this would raise additional questions such as at precisely which level they should be performed (e.g. product type level, on a client basis, etc.).

Moreover, requiring this exercise to be performed at the model level would not be appropriate as the segmentation and granularity of stress testing models do not necessarily match the structure of PD models.

Outsourcing

The concept of “outsourcing” needs to be expanded so that it is clear that it only includes tasks that are external in relation to the whole group. In other words, or is a overall rating systems developed by a parent company or another group entity and used by subsidiaries of the group should not be considered as outsourced systems from the subsidiary’s point of view.

IRB implementation plan

The CRR does not set out a maximum time period for sequential implementation to be completed, nor does it require the EBA to do so in the context of this mandate (see CRR Article 148 (2). Moreover, the EBA’s CP/2014/10 on sequential implementation and permanent partial use explicitly states that “determining the overall time period [for sequential implementation] is solely a matter for the competent authorities”.

We therefore disagree that a maximum time period should be put on the implementation period and consider that it must remain a matter of dialogue and agreement between the institution and its supervisor depending on the nature and scale of the institution’s activities

If however the 5 year maximum implementation limit is retained, the final RTS will have to clarify from which point the clock will start ticking and whether this period includes competent authority approval or not.

Independence of validation function

Q2: 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?

In principle we agree with the required independence of the validation function. This being said, we wish to stress that mandatory organisational independence would go beyond the requirements of the CRR and, that where an organisation procedurally ensures that different staff is responsible for the validation and development functions, this is completely adequate to ensure such independence.

Independence can also be achieved through the use of various governance structures, including separate reporting lines, covenants, or combinations of both; the precise organisation of which should be left up to the firm to determine. Similarly, the level of hierarchical responsibility and the seniority of reporting lines may vary depending on the size and nature of the firm.

In order to avoid introducing a level of prescriptiveness into the RTS that may force unnecessary organisational change, we suggest that Article 10 include a 'comply or explain' approach, in which an institution that has come to a different organisational structure from the one set out by the supervisors has the opportunity to explain why it has chosen that solution and explain why it is an effective approach that meets the required objectives.

Additionally, the current drafting of Article 10 needs clarification so as to ensure consistency with Article 190 (2)(f) of the CRR which requires the credit risk control unit to actively participate in model validation.

Clarification is also required so that it is clear that the proportionality principle applies to institutions at an individual basis if they are not subject to consolidated own funds requirements (as already stated above) and therefore that Article 10 (1) (d) can be applied to the subsidiaries of a global or other systemically important institution when relevant.

Regarding the frequency of the validation process, we wish to stress that a complete annual review of each rating system would be excessively burdensome. If the institution has an annual work plan (as required under Article 11 (2)) that forms part of a comprehensive multi-year review programme in place, an annual in-depth review of each system is not necessary as the firm will still be monitoring each system on an annual basis (at a minimum).

Assessment methodology for assignment of exposures to grades or pools

We consider that the requirement in Article 25(2)(b) to update the rating assignment within a maximum of twelve months after the approval of the current assignment should be extended by at least three months. This is because annual statement publication requirements themselves usually provide some flexibility regarding the exact date of publication, and in some cases this can be up to three months after the end of fiscal year. Thus, the information may not be available to institutions to comply with the twelve months requirement currently set out in Article 25(2)(b).

Definition of default

According to Article 28 (1)(d), when the institution applies the definition of default at the obligor level, once a default is recognised, all exposures to that obligor have to be recognised as being in default across the entire group. While we recognise that as much harmonisation as possible should be sought, we wish to recall that there are still national disparities, for instance in accounting and legal frameworks, that may currently justify different treatments of default events. Moreover, when legal changes are enacted (such as on over-indebtedness laws), they have to be translated into new procedures for default measurements, which may also impede the full international comparability of default definition.

Article 28 (3)(b) of the draft RTS specifically requires firms to consistently apply the default definition across all its retail exposures over time. In our view, this requirement is too restrictive. There can be very valid reasons for applying different approaches (i.e. on the basis of the counterparty or the individual facility level) for retail exposures throughout a firm, e.g. depending on the business model or when a firm acquires new portfolios or entities that adopt a different approach. We therefore suggest that flexibility be allowed in the specific case of retail exposures so that firms apply the definition of default either on an obligor or transaction basis, as long as the alternative approach is applied to well-defined segments (i.e. geographies, entities, etc.) consistently over time. This approach would be consistent with our recommendations with respect to the basis for determining the materiality threshold of defaults set out in our response to the EBA's Draft RTS on materiality threshold of credit obligations past due under CRR Article 178³.

Methodology for assessing the structure of rating systems

We have some concern with the current drafting of Article 37. We fully agree that firms must have adequate processes in place to ensure that risk differentiation is adequate and appropriately monitored and assessed. It is however extremely important that internal standards of tolerance are interpreted in their intended context. In our view, Article 37 may be interpreted too narrowly by certain supervisors who may require automatic corrective action in cases where this would not be warranted, while some others may not. Firms should be given the possibility to explain why a slight deviation from an internal standard may be appropriate on a given portfolio given the broader context of the model and other relevant factors. We therefore suggest the following drafting changes to the article:

³ Our response can be consulted [here](#)

[...]

- (b) *the expected risk differentiation performance is defined by the institution in terms of clearly established **fixed** targets and tolerances **that are appropriate** for defined metrics and tools, as well as actions to rectify deviations from these targets or tolerances **when relevant**; separate targets and tolerances may be defined for the initial development and the ongoing performance;*
- (c) *the targets and tolerances referred to in paragraph (b) and mechanisms applied to meet them ensure sufficient differentiation of risk **given the portfolio(s) in question***

Methodology for assessing overall requirements for quantification of risk parameters

Data requirements

With respect to data requirements, our members would appreciate clarification on what is meant by the “number of exposures” in Article 45 (1) (d). In particular, it would be useful to understand how these requirements would operate in cases where a firm is entering a new market (and where it may therefore have lower volumes). In general, the assessment requirements should be designed so as to allow for the development of healthy competition.

Margin of conservatism

Institutions add a margin of conservatism in cases where errors have been identified or where other relevant drivers indicate it is necessary. We wish to make the general point that, once such errors or other drivers have been corrected, firms should be allowed to remove this additional margin of conservatism without requiring the authorisation of the competent authorities. This should be reflected in the final RTS to avoid divergence in supervisory practices where some authorities may continue to require the additional conservatism whereas others will not.

Methodology for assessing requirements specific for PD estimation

Level 2 requirements related to default are currently spread over several documents (see also our answer to question 5 below), with the consequence that it is difficult to have a comprehensive view of the regulatory requirements in this area. In this context, we welcome the forthcoming publication of the EBA's Guidelines on the definition of default and encourage the EBA to provide the complete set of default related requirements in this document.

Length of the historical observation period

With respect to the length of the required historical observation period, in our view the combination of Article 48 (b) and (c) will result in the removal of the freedom to apply higher weights for more recent data for retail portfolios in the long run (e.g. if at least 10% were to be considered as significantly higher than zero, a retail portfolio with 10 year of relevant data history could no longer be weighted differently). It would be helpful if the RTS could be more specific on this point for retail portfolios.

Q3: 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?

Article 49(3) refers to the notion of “complete economic cycle”, whereas the CRR refers to a time span of 5 or 7 years. Compared to the specific CRR requirement, the notion of economic cycle is subject to interpretation and is likely to be understood differently by different supervisors.

AFME would encourage the EBA to examine this concept further in order to 1) achieve common understanding amongst European supervisors in view of avoiding unnecessarily diverging outcomes and 2) to ensure that this notion is used consistently throughout the regulatory framework (e.g. the notion of downturn LGDs will also refer to economic cycles).

Moreover, we are concerned that the provisions of Article 49(3) will not solve the difficulties that institutions face in cases of missing historical data and may instead introduce an additional bias through the choice of the reconstruction method. Firms will have to make significant efforts to document their underlying rationale for reconstructing default rates for the missing years, yet, given the conceptual arbitrariness of the provisions, we are not at all convinced that the requirement will be interpreted consistently by national authorities.

This being said, the inclusion of a forward-looking perspective in PD estimation is, in principle, a welcome addition to the framework as it may help address part of the criticisms towards models which have been said to rely too heavily on past data and experience. We are however unclear on the rationale behind the requirement in Article 49(3)(b) that forward-looking estimates must be more conservative than the observed average. In our opinion, if internal data is not representative of a complete economic cycle, the entity should estimate a cycle independent PD to remain consistent with the CRR and the Asymptotic Single Risk Factor approach of the Basel agreement. The estimated PD level could be lower than internal ODF as a result, as long as this is adequately justified and documented.

As alluded to previously, the alignment of default to accounting definitions remains an issue. We understand that the EBA may wish to remain “accounting framework neutral”. However, considering the disparities in local accounting GAAPs (and potentially with IFRS), to avoid ambiguity, we would welcome clarification in the RTS that the regulatory definition of default can be aligned with local accounting default definitions.

In summary, we are concerned that the RTS as currently drafted with respect to PD estimation does not yet achieve sufficient harmonisation of supervisory practices and therefore comparability of RWA amongst institutions. We believe the approach requires more consideration. In this context, we also think that the use of expert judgment (subject to the usual validation process) should therefore remain open so as to allow for increased comparability with the other jurisdictions applying Basel framework.

Method of LGD estimation

Q4: 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?

On balance our members consider that the additional guidance is useful and that this clarification will help achieve consistency. For some firms however, we note that this could require significant changes to rating systems, although the segmentation in homogenous risk buckets should contribute to minimising differences.

We understand that the LGD should be based on the number of defaults of counterparties, and not on the number of defaulted facilities, unless the definition of default is defined at facility level (eg for retail exposures).

PD and LGD consistency and treatment of multiple defaults

Q5: Are the provisions introduced in Article 52 on the treatment of multiple defaults sufficiently clear? Are there aspects which need to be elaborated further?

As a general comment and as already mentioned above, we are concerned that the various requirements linked to the default definition will be spread over several references:

- The default materiality threshold as defined in the RTS on credit obligations past due
- Non performing /forborne exposures
- Multiple defaults (Articles 49 and 52 of this draft RTS)
- Forthcoming EBA Guidelines on Default (CRR Article 178)
- BCBS works on modelling constraints for credit risk parameter estimates

Therefore, it is currently difficult to have a comprehensive overview of the definition of default. This situation is all the more uncomfortable as default is a key component of the IRB approach: any change or evolution in this definition implies a heavy workload for firms, an impact on RWAs and material changes that need competent authority approval. Hence, we wish to stress again the importance of regulators coordinating their efforts on this topic.

We would like to raise a number of questions/issues with respect to Article 52 of the draft RTS:

- Do the requirements apply to all types of exposures (they seem to be more adapted to retail exposures)?
- A second default that occurs in a short time frame after the cure period should be reclassified in default for the whole period (starting from the first default date)
- The cure period should be a static period to avoid complexity in the calculation
- Is the counterparty status defaulted or performing during the cure period?
- These requirements mean that default rates will have to be re-estimated to take into account the entire history of a counterparty default in the case, for example, where an obligor defaults before December 31 (static reference date) returns to performing status before this date and then defaults shortly after this date
- Default exit conditions should be made clearer, from both a prudential and an accounting point of view
- How should a firm implement calculations when multiple defaults are spread over various estimation periods?

More generally, the “limited timeframe” notion used to define multiple defaults is not sufficiently precise.

Regarding the cure period definition, it should be clarified that, if the cure period after default is a period during which the counterparty is marked as “in bonis” in the institution’s systems, but should a new default occur during this period, it should be joined to the first default for purposes of risk parameter estimation. Thereafter, a clearer distinction between the exit default criteria and the cure period definition should be made (i.e. explicit reference to Chapter 6 in the text).

Should a slight difference exist between the operational default marking process and the modelled default (cases when modelling criteria are not exactly in line with operational criteria), we think it should not be interpreted as a weakness in the use test principle by regulators.

For non-retail exposures, financial institutions commonly use an observation period after default during which the obligor’s situation is frequently reassessed. This process is commonly referred to a “watch list” situation.

The cure period should then be defined in accordance with the corresponding risk management processes of the institution (which may not necessarily cover the same length of time for each obligor), and the “limited timeframe” referred to above could be linked to the length of the watch list process instead of a fixed number of months (assuming of course that the watch list process covers a sufficient period of time).

It should also be clarified whether the cure period must necessarily be defined in the same way across the institution or if the analysis of the “default experience” could lead to different periods of time or definitions by transaction or counterparty type. The content of the “analysis of the default” experience could also be more explicit and some examples of good practice from the EBA would be welcome. This could include for instance transition matrices from first default to a new default status or other specific studies.

For distressed restructuring, financial institutions often have exit criteria from default that encompass a long period of time and an additional cure period during which the default criteria could be weaker than the initial criteria. However, the RTS does not specify the need to take into account the effect of restructuring in the LGD estimation in cases where no default occurs after the restructuring plan is put in place. We recommend that this issue be addressed in the coming EBA Guidelines on Default.

In order to ensure consistency amongst firms and supervisors, the effect of linking defaults occurring during the cure period to the first default should also be included in the RTS in relation to the specification for LGD estimation.

Methodology for assessing the effect of guarantees and credit derivatives

Q6: 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?

The reference to “funded guarantee” in the text box is not clear (guarantees are by definition unfunded credit protection).

Assessment methodology for stress test used in assessment of capital adequacy

As a general remark, in order to avoid duplication of efforts, we would encourage the EBA to take a more holistic approach to stress testing requirements so that this RTS is more aligned with the regular stress test submissions firms are required to make to the EBA/national competent authorities.

Assessment methodology of own funds requirement calculation

We agree with Article 73 (h) which requires that the IRB shortfall calculation be performed on separate portfolios, i.e. the aggregated portfolio level for defaulted exposures and for non-defaulted exposures and note that there is no CRR requirement to calculate the IRB shortfall on an individual level.

Costs and benefits

Q7: 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?

Changes to the definition of default or PD models will all have material impacts over data series and generate significant work. We expect that this will be amplified by the forthcoming Guidelines on the definition of default which dovetails with this RTS.

The workload will be also affected by the degree of reconciliation required between prudential data and accounting data. Firms may also have to dedicate additional resources to engage with competent authorities to respond to their requests through written statements/interviews as frequently referenced throughout the draft RTS.

In general, the cost of the implementation of the RTS' requirements is expected to be significant, particularly from an operational and organisational perspective.

Q8: What are the main benefits for institutions that you expect by the adoption of these draft RTS?

We support the initiatives aiming at a better comparability of internal modelling approaches both between banks and between jurisdictions. Clarification of the underlying rules in parameter computations is desirable and will contribute to improving transparency and a level-playing field.

Improvements will be all the more significant as and when strong convergence between regulators is achieved. We therefore highlight again the need for the EBA work on these issues to be aligned with the Basel Committee's current review of IRB models.

Q9: 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)?

These draft RTS will trigger significant changes to the rating systems of institutions. Firms will determine the materiality of these changes together with their supervisors.

AFME contact

Jacqueline Mills, jacqueline.mills@afme.eu

+44 207 743 9358