The voice of banking
& financial services

European Banking Authority
Discussion Paper
Future of the IRB Approach

5 May 2015

Dear Sirs

The BBA is the leading trade association for the UK banking sector with 200 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide. Eighty per cent of global systemically important banks are members of the BBA. As the representative of the world's largest international banking cluster the BBA is the voice of UK banking.

We have the largest and most comprehensive policy resources for banks in the UK and represent our members domestically, in Europe and on the global stage. Our network also includes over 80 of the world's leading financial and professional services organisations. Our members manage more than £7 trillion in UK banking assets, employ nearly half a million individuals nationally, contribute over £60 billion to the UK economy each year and lend over £150 billion to UK businesses.

The BBA is pleased to respond to this consultation. [1]

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[1] https://www.eba.europa.eu/documents/10180/1003460/EBA-DP-2015-01+DP+on+the+future+of+IRB+approach.pdf

General Comments

We recognise that trust in internal models has deteriorated recently, and that this has resulted in an increased focus on non-internally modelled capital requirements at a local and global level.

We agree with the EBA's assertion that the IRB framework has proven its validity as a risk-sensitive way of measuring capital requirements that encourages institutions to implement more sound and sophisticated internal risk management practices.

We also acknowledge the EBA's desire to optimise the authority delegated to it in the CRR to make short to medium term improvements to the IRB framework. However we would strongly recommend that the detail of any changes to the IRB framework should be considered within the context of, and wherever possible be aligned to take into account the broader Basel legislative and International Accounting Standards environment.

We are supportive of the process and purpose of the DP. However, we caution that the EBA does not exceed its mandate in making any changes to the CRR.

We welcome the opportunity to support efforts to improve the IRB approach and highlight where we think efforts might be best directed.

We hope that this leads to reaffirmation of the importance of IRB in setting capital in place of other less credible measures that have the potential to supplant it.

Our overall view is that the proposed activities/products are reasonable, though clearly lacking in detail at this stage.

We believe that the proposed timeframe is unrealistic, particularly if material model redevelopment is required. The simultaneous implementation of changes across the industry is likely to put significant pressure on institution's model development and maintenance processes, the regulatory approval process and the finite availability of appropriately skilled resource to meet the demand these changes are likely to produce.

We support the intention to increase the comparability of the internal risk estimates and capital requirements of European institutions and improve the transparency of the models.

However, the benefits of increasing comparability must be considered against the risk of distorting capital requirements by reducing the ability of institutions to identify their own risk drivers, and the risk of encouraging herd behaviour, as highlighted in the paper.

We agree in principle with stronger disclosures, provided that the EBA consults closely with the industry to ensure the requirements are not overly onerous or open to misinterpretation.

In summary

1. We wish to retain the ability to use IRB models to calculate capital requirements using a risk sensitive methodology.

2. We heard in the public hearing that the primary focus of the EBA is to improve comparability and transparency rather than driving greater capital requirements. We encourage the continued focus on this objective.

3. We think that the EBA’s expectations on the timescales for implementation of these regulatory products, which pose a high risk of producing material changes to the IRB framework, are unrealistic and should be reconsidered as the details of these products takes shape.

4.3. Current EBA regulatory developments 13

1. The proposed prioritisation of regulatory products is based on the grouping of such elements that in the EBA’s view can be implemented in a sequential manner.

   Do you agree with the proposed grouping?
   If not, what alternative grouping would you suggest?

Response

While we welcome the EBA's initiative and positive attitude towards risk sensitivity and the recognition of the benefits of the IRB capital framework, we would encourage active and direct coordination with the Basel Committee, including clear, published alignment of timelines. This will help to avoid inconsistencies in the global capital framework and also the potential for duplication of effort.

This is also of particular importance for banks which have a global, cross-border presence outside of the EU where the existence of differing capital frameworks across jurisdictions may lead to an 'uneven playing-field' and inconsistent requirements for local and consolidated capital reporting. The absence of coordination may further exacerbate RWA variance throughout the financial system.

While we are supportive of the grouping in terms of materiality and priority, it does not make sense to finalise rules on PD & LGD at a different time from those for the Definition of Default (DoD). For institutions to plan and implement changes, the rules relating to these aspects will need to be considered together. We would deal with the changes together in one modelling exercise. Furthermore, changing DoD means you also need to make changes to LGD. It would be good for the LGD and CCF work to be simultaneous or to follow the PD work. However, it would be a waste of time and effort to recalibrate “old” LGD models to a new DoD / PD and then have to rebuild LGD. This would avoid multiple iterations of the model development-validation-approval cycle on the same model

Where the rebuilding of models is necessary, it would be desirable for institutions to retain a degree of flexibility as to the sequence of model redevelopments to enable each institution to take into account its business and the materiality of models.

We encourage the EBA to carefully consider where synergies can be realised with work already in train. A key example of this is the implementation of IFRS 9, due by 1 January 2018.

Whilst we recognise the differing philosophies behind the accounting and prudential frameworks, we would encourage the EBA to take into account the requirements under IRB and those under IFRS 9, given the significant challenges involved in constructing and marshalling the relevant data.

We would also like to push for some clarity on how this scheme of work might affect IRB developments that are currently underway, including models currently under developments and approvals pending from national competent authorities.

2. What would you consider the areas of priorities?

Response

Prioritisation should be given firstly, and most importantly, to coordination with the BCBS. Inconsistencies and regulatory divergence across jurisdictions will further exacerbate the issue of RWA variance.

We would encourage the EBA to consider the impacts of broad changes by topic across the different asset classes and portfolios in its proposals.

We think that it makes sense to set out (for ease of comprehension) the revisions by asset class as this will enable specific standards to be developed to address areas where the greatest divergence in comparability is observed.

We agree that the Definition of Default is one of the fundamental building blocks in internal model development.

Calibration of PD/LGD models would then logically be undertaken subsequent (given reliance on definition of default), but implemented simultaneously.

Consideration should be given to assessing the impact of changes on real-life data to determine what the results would look like. We recommend that for material models that it would be beneficial for a QIS and period of consultation to review the impact before making the final decision, in order to preserve the objective of no overall changes to the level of capital required.

Overall we think that there should be a single target date to aim for with implementing all of these changes across all asset classes, so that we have absolute consistency in the application of the changes and make the most of any possible synergies in tacking all asset classes at the same time. The consequence is that this would allow institutions in consultation with the competent authority to determine the approaches to be adopted for prioritising and scheduling the various activities to get to that single target.

3. Do you consider the proposed timeframe reasonable?

Response

No, we believe that restating default histories (as described on page 17, Phase 2) to a standard that enables recalibration with confidence is not possible. Please also refer to answer to question 6 regarding the restatement of history. We believe the timelines to be unrealistic and overly ambitious, particularly for the proposed changes to Definition of Default, and the subsequent calibration changes for PD, LGD and CF estimates.

The time-consuming burden of reconstructing historic data, model recalibration and governance validation will be more evident in larger, complex institutions with large numbers of credit risk models. Furthermore, the estimated increase in volume of model approval submissions - as required by the EBA RTS on changes to IRB models - will require sufficient time for competent authorities to process.

Without compromise on the data history requirements, we would envisage a 5-8 year phased rollout. It is though difficult to propose a prescriptive detailed timeframe (breakdown by years) that would be applicable to all institutions. For larger institutions with a significant number of IRB models (wholesale & retail), it is not possible to provide credible timeframe estimates without further clarity on a number of areas. We believe that the there will be a need to have flexibility and that competent authorities should be given the authority to allow longer timelines for more complex institutions.

For institutions that are focussed on one geographical area with one model for each asset class / segment it may be that the following timeline may be appropriate

- 1 year for changing the DoD and systems,
- 2 years to accumulate sufficient data,
- 2 years to redevelop all models,
- 2 years for RCA approval,
- 1 year for implementation

Coordination should also be sought with all competent authorities to agree a plan and schedule to meet the approval requirements and to ensure that they will have the resources to review all the models.

We would also highlight that in addition to internal resource pressures, many institutions are likely to rely on external resource to implement the necessary changes, and may find that the availability of appropriate external resource is insufficient to meet these proposed deadlines.

Clearly the appropriateness of the timeline is entirely dependent on the extent of the changes required. The most time-consuming changes would be those which require the use of data which is not currently captured in our systems in the way required; retaining some degree of flexibility in the requirements may mitigate this.

In particular do you consider reasonable the proposed timeline for the implementation of the changes in the area of:

a) definition of default;
b) LGD and conversion factor estimation;
c) PD estimation;
d) treatment of defaulted assets;
e) CRM?

a. Definition of default;

Any changes in this area will, at a minimum, require recalibration of all IRB models and approval by the Competent Authority. While the proposals allow a longer implementation period than for the risk estimates, this still appears to be aggressive, particularly given the potential governance bottlenecks outlined above.

b. LGD and conversion factor estimation;

This is entirely dependent on the contents of the draft RTS which will specify the nature, severity and duration of economic downturn for the purpose of LGD and conversion factors estimation. Should these detailed rules differ significantly from our current approach, the work involved could be significant.

c. PD estimation;

This is entirely dependent on the rules for the definition of an economic cycle, the identification of stressed years and how to cope with the absence of the time series of adequate stress conditions to capture a downturn. In the UK the CA has opined that TTC modelling of unsecured retail portfolios is not possible in practice given the changes that have occurred in consumer behaviour over time. Should the EBA require a TTC approach to be developed for all asset classes this would cause considerable difficulty to banks and the CA. If the EBA's interpretation is similar to the UK CA, the impact will be negligible, but again divergence from our current approach could result in significant work.

d. Treatment of defaulted assets;

We believe the impact will be affected by different business models and is difficult to assess.

e. CRM

We believe the impact will depend by different business models and is difficult to assess. It is likely to be more impacted in corporate portfolios where a wide variety of risk mitigation is used and held across jurisdictions.

4. Are there any other aspects related with the application of the definition of default that should be clarified in the GL?

Response

We believe the EBA has covered most aspects related to Definition of Default in the proposed RTS and Guidelines.

We would welcome more clarity on qualitative indicators considered by the EBA. We would still insist that the important role that expert judgement plays is not compromised by the guidelines.

We consider that it would be inappropriate to mandate a uniform approach to the number of days to define default.

5. Do you have experience with adjustments of historical data? What are the methods that you used to adjust historical data, including both internal and external data?

Response

There is limited experience with adjusting historical data, and not in the non-retail portfolios nor to the broad extent that would be required for all models.

There are significant difficulties in reconstructing data and without compromise on the data history requirements, we would envisage a 5-7 year phased rollout approach which would allow for the effect of risk management practices to be reflected and data capture implemented.

While our long-run datasets are likely to be sufficient to identify historical quantitative indications of default, the historical identification of qualitative indications of unlikeliness to pay is significantly more challenging.

It should be noted that experience of such manual back-fill exercises in Retail portfolios have required substantial investment, effort and skilled resource, even for minor definition amendments to minor portfolios. Additionally, appropriate conservatism has been required in order to support underlying assumptions and make the data suitable for IRB use.

Our members consider that it would be impractical to restate all historic default experience should material amendments be made to the qualitative elements of DoD.

6. To what extent is it possible to adjust your historical data to the proposed concept of materiality threshold for the purpose of calibration of risk estimates?

Response

We would have to understand the breakdown of the historic data for the £ of past due – it is probably possible for some portfolios due to this being a quantitative principle.

However, the DoD changes impact other aspects (not just materiality thresholds). Creating the historical data based on new DoD assumes we have the required historical data available to do this. Even if the new DoD can be used to create a sufficiently long historical default series (which is doubtful) it would be misleading and unreliable. This is particularly relevant for non-retail portfolios, where it would not be possible to recreate or simulate active risk management practices and business processes that would have taken place to mitigate risk. Business processes are also aligned to a particular DoD. Therefore assessing past performance on a definition that was not in place at that time will not be a reliable indicator of future performance.

In summary, we do not think the adjustment of historical data is either practical given the significant burdens of IT development, data collection, and the inability to capture business processes / risk management practices which would have had a significant effect on distressed or defaulted customers under the new requirements.

Rather consideration could be given to a forward-looking phased rollout.

7. What is the expected materiality of the changes in your IRB models that will result from the proposed clarifications as described in section 4.3.2? (Risk estimates)

Response

We cannot answer confidently without understanding details of the clarifications. Until we have something definitive it is difficult to be specific.

Potentially the impact could be very high and necessitate complete rebuild of all elements of rating systems, processes, internal organisational structures and likely changes to data infrastructure. When considered alongside parallel changes required for the implementation of IFRS9, the potential cost implications could be considerable.

We would also encourage assessment of the scope, potential benefits and prioritisation of each activity to ensure that the EBA's products continue to focus on material areas of divergence or incomparability.

We would however note that the PD and LGD estimation proposals will introduce material changes as it relates to margins of conservatism, downturn and stress specifications.

Multiple defaults: This may have a significant impact, but we would have to undertake further analysis to assess the prevalence of multiple defaults in our portfolios. This change would, at a minimum, require recalibration of all IRB models. Any change to the count of default events could materially impact PD and LGD models.

We would have expected this aspect to be considered under the 'Definition of Default' section rather than in the 'Risk Estimates' section, and would suggest that the EBA consider including this in the earlier 'Definition of Default' regulatory products as outlined in the timeline.

PD: The impact of this is potentially high, dependent on the rules for the definition of an economic cycle. It is not clear what would be required if datasets are insufficient to cover a full cycle. We also do not want to the definition of default to be set at a specific number of days. We believe that for some portfolios the competent authorities should retain their discretion to retain 180 days (i.e. for residential mortgages).

Downturn: The impact of this is potentially high. More guidance on what constitutes a downturn would be welcome, as would guidance on what parts of the LGD calculation would be affected by this.

8. Do you consider the direction of the proposed changes adequate to address the weaknesses and divergences in the models across institutions?

Response

Yes, we support the direction of the proposed changes and believe that it continues the work already underway to reduce divergences and address identified weaknesses.

While harmonisation is welcomed as a method to improve comparability we would caution that it does not detract from, or become an obstruction to risk sensitivity and internal risk management practices.

There is an assumption of equivalent underlying model philosophies that is unlikely to be the case in reality. The benefits of increasing comparability must be considered against the risk of distorting capital requirements by reducing the ability of institutions to identify their own risk drivers, and the risk of encouraging herd behaviour, as highlighted in the paper.

Our view is that the proposed changes would reduce some of the variability in institutions' modelled risk weights, and so increase comparability across institutions. However, some variability will inevitably remain, particularly where differences in rating philosophy exist (e.g. Through-the-Cycle vs Point-in-Time approaches).

9. Are there any other aspects related with the estimation of risk parameters that should be clarified in the EBA guidelines?

Response

Yes – the aspects cited as a source of difference on page 13 are not subsequently discussed, particularly clarity and guidance around the calculation of maturity which is a driver of RWA and therefore potential variance.

We would welcome clarification and standards on calibration techniques.

We would also support further guidance and harmonisation particularly on the topic of Low Default Portfolios as they often represent important client relationships. We draw the EBA attention to the following:

- A low default portfolio is not the same as having no data.

- A low default portfolio with a lot of history (i.e., through various economic and other circumstances) provides good evidence to build PD models with robust estimates for PD.

Suggestions of topics for clarification and focus:

i) LDP methodologies and when they can be used
ii) Harmonised definition of LDP
iii) How to address data gaps/issues for LDPs
iv) Encouragement and incentivising cross-institution data pooling

10. Do you have dedicated LGD models for exposures in default that fulfil the requirements specified in section 4.3.3.(ii)? (calculation of ELBE and LGD in default)

Response

Some institutions do have Retail IRB portfolios for which they have separate downturn and PIT LGD models or model segments for in default exposures. But there is not a consistent approach across members.

But, there have not been dedicated LGD-in-default models for non-retail portfolios.

The aim would be to actively work towards a consistent target approach (across jurisdictions and products/assets) in line with the DP, however noting that longer timelines would be required to support further model development and changes.

We believe the EBA should consider how this particular topic links with the provisioning requirements of IFRS9 when further developing these proposals.

11. Do you consider the direction of the proposed changes adequate to address the weaknesses and divergences in the treatment of defaulted assets across institutions?

Response

We are supportive of the proposals and the direction they are heading to provide more consistency and clarity on the treatment of defaulted assets.

We also agree that more specific guidance would clarify the conceptual basis of both the LGD and ELBE metrics, and also improve the level playing field.

We would need to understand how strictly the guideline would be enforced as well as the timelines, and given the lack of consistency in the industry an appropriate implementation period would be required.

12. What else should be covered by the GL on the treatment of defaulted assets?

Response

We believe the proposed guidelines cover the relevant points, however consideration should be given to the implementation of IFRS9.

We would remain cautious should the final guidelines become more specific or granular.

We recommend clear guidance is given on the appropriate application of discount rates, administrative costs, etc to LGD estimates on defaulted assets.

4.3.4. Scope of application of the IRB Approach 29

13. What are the impacts for the institutions that should be considered when specifying the conditions for PPU and roll-out?

Response

We would refer the EBA to the response to its consultation EBC-CP-2014-10 in September 2014.

The proposed 8% threshold is restrictive and unwarranted, and lacking a clear mandate from the provisions of the CRR.

The proposed conditions need to take account of, but not limited to:

- Presence in emerging markets where modelling of exposures are difficult to achieve
- Proportional consolidation of associates where insufficient granular detail and control is available to model exposures under IRB
- Potential for inequitable distributions of exposures across asset classes where threshold proposals are set at that more granular level

Managing rollout of IRB to a 92% target within a large and global institution is likely to introduce additional model risk through incentivising institutions to develop multiple bespoke models for its smaller or specialist portfolios. Meeting roll out plans are also conditional on models being approved for use.

Therefore, competent authorities wishing to enforce timescales and stringent roll out plans in terms of proportion of assets ultimately on the IRB approach, will find themselves receiving applications where the primary goal of model implementation is to meet roll out plans rather than for strong risk management reasons.

Small closed portfolios should be able to be easily exempted. The expense and resource is disproportionate to the risk posed to institutions. A possible solution is to have robust under-estimation processes in Pillar II – which would need supervisory alignment across territories.

14. Do you expect that your organisational structure and/or allocation of responsibilities will have to be changed as a result of the rules described in section 4.3.5?

Response

We agree that the most significant impact in this area is the guidance around independence of the validation function.

The proposed changes will impact differently across organisations, dependent on the structures in place.

We think the proposals to completely separate model validation and model development functions are unnecessary where independence is evident already in the form of independent model review and internal audit functions.

15. Do you agree that CRM is a low priority area as regards the regulatory developments?

Response

We agree that the specific proposals for CRM as described in the DP are of lower priority. Nevertheless, we believe the CRM framework to be very important and warrants careful consideration of enhancements to the scope and eligibility of credit risk mitigants recognised under the Foundation approach.

This should be closely coordinated with the BCBS.

4.3.7. Conclusions 36

16. Are there any other significant intra-EU or global discrepancies?

Response

To ensure a global 'level playing field' and regulatory consistency in the global financial system, reducing these discrepancies and harmonisation will be beneficial towards reducing RWA variance.

Pillar II

We urge the EBA to also include in its scope the calibration of Pillar 2. We think that after the changes to P1 have been implemented the P2 add-on buffers for underestimation and concentration risk will need to be re-examined in order to ensure that the overall level of capital is unchanged. This in turn may have an impact upon the approach to stress-testing P1 and P2.

0% risk weight

In particular, the 0% risk weight available to EEA Sovereign exposures remains an exception to other global regulatory provisions.

Definition of Default

No absolute or relative threshold for definition of default is set by supervisors in certain other regions, but can be set internally (and reviewed by supervisors).

17. Do you agree that the area of disclosures needs to be strengthened, in particular with regard to disclosures related with the benchmarking exercise, for instance by publishing them on the EBA website?

Response

We agree in principle with strong disclosures, provided that the EBA consults closely with the industry to ensure the requirements are not overly onerous or open to misinterpretation.

We support transparency as an aid to external parties to understand institutions and internal models, and that disclosure is a fundamental avenue to achieve this. However we would caution that the extent of information disclosed needs to be understandable and not lead to divulging sensitive internal information.

We do not think that the proposals to increase disclosure through publication of benchmarking exercises, or other similar exercises would be helpful.

As explained in the response to the EBA's RTS on benchmarking, we believe there are a number of flaws and issues that need careful interpretation (this can only be achieved in consultation with an NCA).

We would recommend that the existing framework of Pillar 3, which has been enhanced in recent years, be utilised for disclosure.

18. Would you support EBA Guidelines targeted at disclosure requirements related with the IRB Approach and taking into consideration the proposals of the Basel Committee on those requirements? Which current disclosure requirements should be given the priority? What should be the timetable for such Guidelines?

Response

Refer to our response to question 17.

Again, we agree in principle with stronger disclosures, provided that the EBA consults closely with the industry to ensure the requirements are not overly onerous or open to misinterpretation.

Timetables should be discussed once the EBA has a clearer idea on the proposed content of additional disclosures.

19. Would you like to see any modification of the reporting framework implemented in terms of IRB exposures?

Response

We are not requesting any specific modifications, but enough time must be given to allow changes to systems to be implemented.

It would also be useful to align requirements to those under Pillar 3 as far as possible, in order to reduce duplication.

4.5. Possible future regulatory developments 48

4.5.1. Low default portfolios 49

20. What would you consider an appropriate solution with regard to the definition and treatment (modelling restrictions) of the low default portfolios?

Response

We recognise the challenge that the EBA has to define an approach for LDP, in particular the matter of modelling high-quality Sovereign exposures.

We think that further detailed consideration should be given to the consistent treatment of at least the G20 countries, and even the possibility of assigning the zero risk weight to these sovereigns.

As referenced in the response to Question 9, a low default portfolio is not the same as having no data. We think a low default portfolio with a lot of history (i.e., through various economic and other circumstances) provides good evidence to build PD models with robust estimates for PD

4.5.2. Permanent partial use of the Standardised Approach (PPU) 50

21. How would you ensure appropriate use of the IRB Approach in a harmonised manner without excessive concerns of the so called 'cherry picking'?

Response

This is reported in Pillar III so via benchmarking and supervisory judgement for individual institutions. PRA approach here has been a good example in the past with the aspirational 85% coverage threshold.

With regard to the application of capital add-ons to IRB banks applying the Standardised approach in data rich portfolios, there should be clear conditions / guidelines / parameters which state when A/FIRB is permitted. Only if these conditions can't be met then Standardised should be applied.

4.5.3. Harmonisation of exposure classes 52

22. Do you see merit in moving towards the harmonisation of the exposure classes for the purpose of the IRB and the Standardised Approach?

Response

Yes, SA should be harmonised with IRB. In particular, having an aggregate "in default" SA asset class is inappropriate. This should be dealt with in each asset class.

4.5.4. Philosophy of the rating models 53

23. Would the requirement to use TTC approach in the rating systems lead to significant divergences with the internal risk management practices?

Response

The use of TTC would be a concern and we disagree with proposals for a mandatory requirement. Rather, firms should retain the flexibility to adopt an internal approach that is in line with their risk appetite and business.

With respect to Retail models, in the UK the PRA has accepted the use of PiT operational scorecards as a critical input into regulatory PD. The option to do this for retail lenders should continue as it is a critical aspect of use test compliance.

The use of TTC for Retail portfolios would:

1) Introduce a requirement that could not be reasonably met by all institutions for all modelled portfolios. For example the UK CA has opined that TTC modelling of unsecured retail portfolios is not possible in practice given the changes that have occurred in consumer behaviour over time; and

2) Make comparability of RWAs more difficult since interpretation and application of TTC is more varied and contentious than PIT.

In summary, we do not support the mandatory use of TTC for internal risk management purposes. In reality, the appropriateness of PiT or TTC for internal risk management will differ across firms based on their risk appetite, portfolio type, business model and structure. For example, an institution that originates assets to hold and one which originates assets to manage / hedge will take differing views.

4.5.5 Data waiver 54

24. Do you agree that the possibility to grant permission for the data waiver should be removed from the CRR?

Response

No.

In view of the fact that Basel II introduced this requirement in January 2008, when the majority of institutions applied (and received) IRB permissions, this will have little effect on those established institutions. However, the intent of this provision was originally to reduce the barriers to entry for new institutions wanting to apply for an IRB permission, and the removal from the CRR could be considered as introducing this barrier again.

Other aspects

25. Are there any other aspects of the IRB Approach not discussed in this document that should be reviewed in order to enhance comparability of the risk estimates and capital requirements?

Response

We believe that the answers to the other questions are sufficient.

End of Response