Andrés Portilla
Managing Director Regulatory Affairs

May 5, 2015

Andrea Enria
Chairman
European Banking Authority

Re: IIF RWA Task Force Response letter to the EBA Discussion Paper "The future of the IRB Approach"

Dear Mr. Enria,

The IIF Risk Weighted Assets Task Force (IRTF) is a group composed of approximately 40 large international banks that have worked to develop a multi-pronged approach to enhance internal model based capital approaches. This work has culminated in the publication of a number of reports, the most important of which is named 'The IIF RWA Task Force Final Report' and was published in November 2014.

The IRTF supports the work of the EBA aimed at enhancing the robustness and comparability of the internal risk estimates and capital requirements, and in restoring trust in bank's internal models. The IRTF concurs with the EBA's overall perspective that the IRB framework has proven its validity as a risk sensitive way of measuring capital requirements, which encourages the implementation of sound and well-developed internal risk management practices.

Therefore, the IRTF's views are much aligned with those of the EBA as outlined in the EBA Discussion Paper (DP) "The future of the IRB approach," and we welcome the opportunity to comment on the proposals contained therein.

As indicated in the IRTF Final Report, the industry is committed to strengthening the regulatory capital framework while preserving a system where capital requirements are commensurate with the actual risks incurred by each bank. The IRTF Report aimed to contribute to these efforts by undertaking a comprehensive analysis covering all aspects of internal modeling approaches and RWA generation culminating in the formulation of detailed recommendations for improvement and harmonization.

The IRTF findings indicated that there are RWA variance drivers in every single point of the model life cycle, many of which stem from the differences in the underlying risk profiles.

Notably, divergence in the RWA associated with seemingly similar types of exposures can be the natural byproduct of differences in:

- Bank-client relationship (including the so-called 'home bias')
- Portfolio concentrations, size of portfolio, risk and admission policies
- Product features
- Market specific features and legal and social contexts
- Recovery strategies
- Supervisory interventions

- Portfolio or bank specific data deficiencies, leading to differences in conservatisms (margins of prudence) and modeling approaches.

The current capital framework is set up such that these differences are captured in bank's internal models and hence lead to legitimate and desirable RWA variance. For instance, the EBA published in 2013[1] summary findings which indicated that (i) the differences in implementation of the IRB Approach are linked to different bank and supervisory practices, and that (ii) a key component is due to the "inherent risk in the portfolios of the banks and represents drivers of differences in capital requirements which are not intended to be eradicated by the IRB Approach regulatory framework."

Other drivers of RWA variance, such as, for instance, differences in definitions, technical (binary) modeling choices unrelated to risk representation, local Basel and other standards as well as different supervisory practices are less desirable even though they are the direct result of ambiguity in the Basel rules and subsequent different interpretations and implementation by banks and their supervisors.

The IRTF is in favor of eliminating this unwarranted variance, but wishes to emphasize the importance of retaining risk sensitivity, i.e. the link between a model and the portfolio risk, risk policies and strategies said model is supposed to reflect. For that reason, the IRTF urges the EBA to embrace the IRTF-suggested approach of distinguishing between, on the one hand, the need for regulatory guidance to eliminate ambiguity in the Basel regulations and, on the other hand, the need for supervisory principles which would be applied consistently by supervisors while respecting portfolio-specific features and risks. Harmonization should therefore not jeopardize risk sensitivity.

The IRTF supports the effort of the EBA to go beyond the mandates included in the CRR and believes it is paramount to undertake a comprehensive effort to reduce undue RWA variance.

We further believe that evaluating and benchmarking PD, LGD and EAD models in isolation will reveal discrepancies between banks which may prove to be much less material when assessing overall portfolio RWA and EL results taken together. For instance, without a comprehensive analysis, the domino effect of differing definitions of default and the interaction of LGD and EAD will not be captured in full if the risk parameter models are assessed in isolation.

In short, given the interconnection between different drivers of RWA variance, an all-encompassing review of RWA variance drivers should be conducted in order to resolve the issue in a fully satisfactory manner.

The IRTF is further of the view that being able to explain the differences between outputs is more important than banks producing the same outputs. Comparability can be best achieved by creating a capital framework based on internal models that are largely harmonized in approach, but still reflective of the portfolio risks and the bank's internal risk management practices and strategies. Investors, analysts and rating agencies should be able to compare each bank's RWA to the RWA of its peer banks, and understand model performance by looking at all main dimensions and factors driving a RWA result. Where banks' portfolio risks are not identical due to one or more of the above listed factors, they may therefore not be fully *comparable*, but enhanced disclosure can ensure they *can still be compared*. We do not

[1] European Banking Authority Report, *Summary report on comparability and pro-cyclicality of the IRB Approach* (17 December 2013).

believe that arbitrarily enforcing superficial comparability contributes in the end to financial stability. On the contrary, it could well create a false sense of security and hide true risks.

In the same context we think there is no ground to link the lack of comparability to the robustness of models. The IRTF appreciates that the EBA recognizes that the actual implementation of the IRB Approach has led to different supervisory practices for assessing the adequacy of internal models and addressing model deficiencies, all of which have contributed to the increased variance in RWA. These also impacted banks' model development and calibration. While this may result in potentially cumbersome and costly changes for individual banks and supervisors, the development of best practices supervision and harmonization of banks' modeling approaches will ultimately serve the objectives of simplicity and comparability even to the point of making other changes to the capital framework redundant.

While we support harmonizing internal modeling and supervisory practices over time, we equally hold the view that any changes to rating systems, data deployed, and risk parameter estimates should be implemented with due consideration of reasonable timeframes, and with the appropriate transitional arrangements to avoid disruptions in key internal risk management and capital planning processes such as capital allocation, loan origination, risk-based pricing, etc.

We share the belief of the EBA that a truly global alignment of the rules is necessary to create a level playing field across jurisdictions and to avoid misinterpretation in cross-border comparison. Fragmented regulation and associated supervisory and bank practices may well distort future benchmarking exercises by the BCBS and would compromise the pursuit of enhanced transparency in Pillar 3 disclosures. Furthermore, the IRTF believes that the EBA guidance should be developed on a principles-based basis, at least in first instance, leaving room to accommodate further changes if different approaches are taken at the BCBS level.

To the extent the EBA is front running the reduction of RWA variance, the EBA has a unique opportunity to pave the way for a capital standard that is risk sensitive while based on harmonized modeling approaches. Therefore, we note that a successful effort by the EBA would limit the perceived need for capital floors or other interventions in internal models that would jeopardize risk sensitivity and decouple the true risks in a bank's portfolio and the required regulatory capital. With this in mind, we urge the EBA to share and coordinate its proposals with the BCBS so that the goal of harmonization of standards and practices across the globe can be achieved.

In case you have any further questions pertaining to this response letter, please contact Barbara Frohn at bfrohn@iif.com or + 1 202 857 3311.

Sincerely,

Andrés Portilla
Managing Director, Regulatory Affairs
IIF

Detailed Comments

The comments below reflect the views and findings of current IRTF member banks. They do not aim to answer all questions listed in the Discussion Paper; rather, they are geared towards helping along EBA's credit risk model and RWA-related thought processes. Our comments follow the framework of the EBA DP, and include references to the commented paragraphs[2].

Comments on Current EBA Regulatory Requirements

22 Main Sources of Variance

The IRTF last November published its report in which it detailed a list of sources of variance, and provided an impact sensitivity analysis with the help of data provided by Global Credit Data (GCD)[3]. Based on this work, the IRTF through its advocacy work, presented regulators with its list of main sources of variance. Box 1 presents the main issues in order of prioritization for non-retail exposures, and Box 2 below provides a similar list for retail exposures. Although the IRTF agrees with the sources of differences listed in the EBA DP, its own prioritization (based on the findings in the IRTF analysis) shows some notable differences. For non-retail portfolios and models, they are presented *in order of prioritization* as follows in Box 1:

Box 1: Non-Retail Main Issues in order of prioritization
1. PIT – TTC – Hybrid
2. Segmentation PD/LGD/EAD
3. (for Low Default Portfolios only) supervisory treatment and internal identification of LDP for both PD and LGD modelling purposes
4. Margins of Prudence
5. Discount rate
6. Downturn LGD / EAD
7. Length and choice of data series PD/ LGD/ EAD. This issue relates to the data for model build, for calibration and for model horizon
8. Number of grades PD and LGD
9. Cure rates and cure periods
10. EAD/ CCF and use of unused unconditionally cancellable
11. Treatment of unfunded credit protection
12. Materiality threshold and technical default
13. Unlikeliness to pay triggers
14. Defaulted assets and ELBe
15. Variable or fixed time horizon EAD

[2] For each comment below we quote the relevant section and sub-header of the EBA DP, and the number of the paragraph (i.e. 22 Main Sources of Variance). We noticed the duplication of paragraph numbers 23-30 in the EBA DP.

[3] Global Credit Data (GCD), is a not for profit initiative to help banks to measure their credit risk, owned by its 47 member banks across Europe, Africa, North America, Asia and Australia. It has the world's largest database of defaults and PD estimates for large corporates, banks, SMEs and specialized lending.

For retail portfolios, Box 2 presents almost the same list of main drivers of RWA variance with a few marked differences.

Box 2: Retail Main Issues in order of prioritization
1. PIT – TTC – Hybrid
2. Segmentation PD/LGD/EAD
3. Margins of Prudence
4. Discount rate
5. Downturn LGD / EAD
6. Length and choice of data series PD/ LGD/ EAD. This issue relates to the data for model build, for calibration and for model horizon
7. Number of grades PD and LGD
8. Cure rates and cure periods
9. Materiality threshold and technical default
10. Obligor vs. facility default
11. Days past due
12. Defaulted assets and ELBe
13. Variable or fixed time horizon EAD

It is important for the issues listed above to be given a priority status, ideally, but not necessarily, in the order presented above. For the IRTF Impact Sensitivity Analysis real data was used, extracted from the data pool of the data consortium GCD which showed that the issues analyzed in the IRTF Impact Sensitivity Analysis have the potential to create significant differences in RWA outcomes. Upon request, the IRTF can provide more supporting analysis in this area. However, based on expert judgment, the IRTF feels that, while all drivers should preferably be subjected to EBA analysis, the estimated effect on RWA of some of the drivers listed in the DP is not material:

1. Multiple defaults
2. Frequency of model review
3. Governance

Conversely, we observe that some drivers may have been underappreciated or are absent in the DP.

a. Segmentation

We note that segmentation was not included in the list contained in paragraph 22 of the EBA DP. We urge the EBA to take account of the findings of the IRTF Final Report and the IRTF Impact Sensitivity Analysis, which shows the striking effects of segmentation granularity[4]. As an example, in the case of LGD, merging two different pools into one can significantly alter the LGD value applied to the pool with the smaller number of defaults; the impact on one particular portfolio used in the Impact Sensitivity Analysis amounted to 15% on LGD and RWA.

[4] IRTF Final Report, Chapter 1.5 Impact Sensitivity Analysis, p 169-170, p 180.

b. Supervisory adjustments related to macro-prudential concerns

In some jurisdictions, supervisors have imposed adjustments to model outcomes that cannot unequivocally be related to model or data deficiencies. They are generally applied to all banks within the jurisdiction irrespective of the quality or level of conservatism embedded in the individual models. Such adjustments aim at increasing capital cost to discourage further growth of particular portfolios, avoid overheating of the local economy or even incentivize deleveraging by banks. Such adjustments are applied inconsistently across jurisdictions (i.e. at various levels in the capital computation process) and therefore can reduce cross-border comparability.

Examples are local multipliers or adjustments for mortgage-related RWA.

c. Interplay LGD-EAD

This relates to the comparison of model derived LGDs in isolation disregarding the fact that they may be based on different CCFs. A bank using a 100% CCF is expected to exhibit a lower LGD than one using a 50% CCF. Hence, benchmarking LGD as an isolated metric would be inaccurate. Benchmarking of LGDs should therefore be done in combination with CCFs. This is a relevant topic in light of regulatory and analyst-related pressure to explain why an individual bank's LGDs are lower than those of peer banks.

d. Delineation credit risk losses – operational risk losses

This relates to the treatment of operational events such as fraud cases. Some banks take those losses within credit risk while others include it in operational risk loss databases for the purpose of their AMA approach. As a result, the first type of banks will exhibit higher own historical LGDs but lower operational risk capital than the second type. If regulators then perform a benchmarking exercise of LGD levels, this would be like comparing apples with oranges. The result could be that the first type of banks will be pressured to increase their LGD model calibration and may also be seen as an outlier in its AMA results, ending up being punished twice while the others would compare favorably with the majority of their peers.

e. EAD of Short Term, uncommitted exposures

This relates to short-term, uncommitted exposures (e.g. Trade & Commodity Finance, interbank exposures).

EAD for these exposures generally decreases before a default occurs, as banks reduce their exposures when first warning signals emerge. As a result, the observed LGD at default is calculated over a lower EAD than the one used, say, one year before default. As a result, back testing often fails or leads to a higher unjustified calibration. This can also lead to variability depending on how banks manage this back testing (one possible option is to calculate the LGD as a percentage of the EAD for example 6 months before default).

f. CCFs for undrawn lines and off-balance contingency products.

This area is important for Trade Finance in particular and has never been analyzed extensively by regulatory authorities, resulting in banks making their own choices and assumptions and creating undue variability. For instance, when sub-limits are used or different products are drawn under a common main limit, the estimation of the right CCF is difficult because LGDs and CCFs are expected to be estimated at facility level, while observed CCFs and LGDs will be at product (or sub-limit) level. Banks therefore need to

aggregate based on assumptions related to utilization of lines/products. Supervisory instructions, if any, diverge. This can lead to relevant variability.

22 Permanent Partial Use and roll-out effects

Regarding the second bullet point in paragraph 22, we believe that the Permanent Partial Use (PPU) and the roll-out effects can be remedied by enhanced disclosures, rather than by issuing additional guidance. More important in future could be the effect of possible new capital floors which could complicate RWA comparability as internal model outcomes could or could not be hit by such capital floors and cliff effects cannot be ruled out further complicating trend analysis and comparability over time.

28 Deadlines and Prioritization (p. 15 of DP, we note that the numbering on the EBA Draft repeats itself)

IRTF Members agree with the proposed prioritization and grouping of the EBA products. However, the IRTF wishes to express some concerns about the implementation timelines. The concerns are threefold:

First, some of the changes that will be forthcoming as a result of the RTS and GL in Figure 2 of the DP entail extensive IT, data and capital computation change processes, but also have wider repercussions. For instance, adjustments to the definition of default resulting in the need to update data retroactively will take longer than estimated, and given that timelines are interconnected this will push back the entire implementation timeline. In this area there are therefore potentially major repercussions for PD and LGD model calibration and the use of internal history. These linked processes have to be dealt with in conjunction mandatorily. In a similar vein, changes in materiality thresholds and the choice of Option 1 or Option 2 of the EBA RTS[5] are likely requiring material changes to many banks' processes and model development and calibration. In such cases, implementation timelines should be much longer;

Second, the timelines may conflict with (later) BCBS timelines and create uncertainty for banks operating both in Europe and in other regions; and

Third, the proposals in Figure 2 of the DP disregard possible work on closely linked issues listed in Section 4.5 of the DP. The IRTF can help identify possible impediments to a smooth transitioning process which result from such interlinkages. Notably, the issues related to CRM are closely related to LGD and conversion factor estimation, therefore the relevant elements of CRM should already be included in the RTS on "LGD and conversion factor estimation" and not be pushed back to later.

Further, in Figure 2 of the DP the proposal related to the treatment of defaulted assets implies that the EBA plans on producing guidelines for IRB shortfall calculations. We recommend that the EBA waits until the final paper from the BCBS on ECL models is published and more clarity is obtained on the effect IFRS9 and the equivalent US GAAP changes have on provisioning levels before issuing further guidelines. We further believe that a global alignment of the rules is necessary to avoid misinterpretation in cross-border comparison.

[5] EBA Draft Regulatory Technical Standards on materiality threshold of credit obligation past due under Article 178 of Regulation (EU) 575/2013

Comments on Definition of Default

25-30 (i) Quantitative indication of default - Materiality Threshold

The IRTF supports the work of the EBA aimed at reducing the variance in the application of the definition of default by banks and supervisors. We share the view that the definition and treatment of materiality thresholds affect the number of defaults taken into scope in the default rate, consequently having a knock-on effect on loss rates. We welcome the EBA-proposed common structure, i.e. recognizing absolute versus relative thresholds, as this will ensure consistency and a level playing field. It is important to note that historically banks have used materiality thresholds as a safety valve to ensure that default is not declared in unnecessary situations.

We note that the referenced EBA proposed RTS[6] language goes one step further, by not only proposing definitions and maximums levels of absolute and relative thresholds, but by also proposing to impose a choice between two treatments. The treatment briefly discussed in the DP seems to suggest that default would be recognized when either the absolute and relative threshold is breached, i.e. Option 2 in the RTS. The IRTF supports this approach.

In the IRTF report we recommended a materiality threshold in the form of a maximum percentage of the defaulted exposure (i.e. a relative materiality threshold), determined by asset class, on condition that the use of this threshold has no material effect on the default history. While this is not fully in line with the proposal in the DP we do not have major objections to the current EBA proposal, as long as further differentiation (e.g. between large corporates and SMEs) is introduced to avoid the inclusion of immaterial exposures. This is especially relevant in a context of number weighted default rates.

The IRTF however does not support the EBA proposal to set different levels of thresholds across jurisdictions, in particular if the bank already takes into account technical defaults. It is also our view that materiality thresholds should not supersede qualitative unlikeliness to pay triggers that firms may use to trigger default, i.e. firms should be able to depend on more qualitative signals and not purely on materiality thresholds.

Referring to the IRTF Final Report[7], we note that the proposed EBA Materiality Threshold standard would imply a major change for many EU based banks and banks with operations in the EU.

We therefore believe that implementation needs to be gradual, and should be accompanied by a long grandfathering period to mitigate the risk of un-comparable data series.

We also note that the DP does not address a closely related issue which is the variance in the definition and inclusion or exclusion of technical defaults in the default and loss history. Some banks and supervisors equate the implementation of materiality thresholds with the desire to avoid pollution of default and loss data by technical defaults. The scope of technical defaults found in the IRTF Final Report ranges between system errors, loan covenant breaches and non-financial reasons. We encourage the EBA to link the two issues, and to provide a uniform definition of technical defaults and their associated treatment while retaining flexibility for specific cases. Whether a bank includes or eliminates technical defaults from the calculation impacts not only the measurement of the default rate, but also of loss and cure rates. Banks that choose to include technical defaults will have higher default rates, but presumably lower

[7] IRTF Final Report, p. 29-33.

LGD rates. Figure 6 of the IRTF Final Report on the definition of default illustrates this. We advocate that the decision about materiality thresholds be based on a uniform definition and treatment of technical defaults.

32-34 (ii) Qualitative indicators of default - Unlikeliness to pay triggers

With regards to the qualitative indicators of default presented in paragraphs 32 through 35, the IRTF highlights the following points.

The findings of the IRTF Final Report coincide with those presented in paragraphs 32-34 of the DP. We commend the EBA's initiative for providing practical guidance on the recognition of each of the qualitative indicators of unlikeliness to pay. We understand that the DP only indicates what the RTS and the GL will expand on in more detail, however we reiterate our recommendation that some minimum criteria need to be set for unlikeliness to pay triggers per asset class in order to adequately address the RWA variance. Further, a closer alignment between accounting and prudential rules would enhance transparency and avoid unnecessary duplication of internal bank procedures.

The IRTF acknowledges that the EBA already provided a clear definition for forbearance and concessions in the context of regulatory reporting, and that the issue arises mostly from jurisdictions outside the EBA countries, where uniform definitions for forbearance, refinancing and restructuring are lacking. The IRTF believes that as long as national forbearance practices diverge, default triggering will continue to be diverse and could have a material impact on default definitions used.

35-36 (iii) Return to non-defaulted status

The IRTF shares the view that special attention should be paid to the timing and conditions of return to performing status of clients/assets. An important element of the definition of cure rates is the observation period before defining the exposure as cured. We urge the EBA to examine the IRTF findings on cure rates, cure period, and the related treatment of multiple defaults.[8]

37 Other aspects of the application of the definition of default

The IRTF supports further work on the key topics of the definition of default. In addition to issues pertaining to the use of external data, we cite default contagion (the application of the definition of default at facility or obligor level; obligor contagion, cross default) as a relevant issue to be included in the analysis.

More generally, we believe the priority issues in the area of the definition of default are:

- Days past due: number and calculation methods
- Unlikeliness to pay
- Materiality threshold and technical default
- Default contagion (notably facility vs obligor notion of default)

[8] *Ibid*, Chapter 1.1, Section 6; and Chapter 1.5 IRTF Impact Sensitivity Analysis.

Comments on Risk Estimates

40-44 General Comments

The IRTF fully subscribes to the objectives of the EBA to ensure uniform application of the IRB requirements while leaving flexibility for banks to capture the true risks in their models. However, the IRTF observes that the items listed in paragraph 43 can only be successfully analyzed when taking full account of, and including, the items listed in Section 4.5 of the DP. We notice some overlap in the descriptions in Sections 4.3.2. and 4.5 and believe that the analysis on PD and LGD computation should indeed take all items of Section 4.5 in scope. While we acknowledge that this potentially affects the foreseen timelines of Figure 2 of the DP, exclusion of those items likely render the PD and LGD related RTS and GL ineffective.

45-48 (i) Treatment of multiple defaults

In relation to the treatment of multiple defaults, we agree that multiple defaults may impact both PD and LGD. However, we note that the variance in the treatment of multiple defaults stems from the different practices for grouping multiple defaults into a single default, and refer to the IRTF findings[9]. We recommend[10] for the practice of grouping multiple defaults into a single default to be harmonized.

Nevertheless, as stated before, we do not believe that the issue of multiple defaults is a material driver of RWA variance. According to the data of the Global Credit Data Consortium, many banks do not immediately put exposures back in non-defaulted status and thus multiple defaults within one year are rare.

49-50 (ii) Default rate

While the IRTF agrees that specific guidelines in the definition of the denominator and numerator in calculating the one year default rate would have a positive bearing on RWA harmonization, there is a larger range of default rate related issues that could lead to RWA variance. The IRTF devoted a section in the PD chapter[11] of the report to identifying various factors. Apart from the treatment of multiple defaults in the one-year horizon mentioned in the EBA paper, the following should also be addressed:

- Treatment of inflows and outflows in the default rate calculation;
- Treatment of outdated ratings;
- Exposure-weighted PD verses number-weighted default rates; and
- A bank's choice of the floating-term or fixed-term approach to the one-year horizon can also lead to RWA variance.

51-54 (iii) PD Estimation

The IRTF report captured the effect of diverging practices in using long-term average data in PD modeling. The IRTF believes that clarity on the definition of "long-term average" as well as "economic cycle" would contribute to the harmonization of RWA. As the EBA prepares for the work on this topic, the IRTF would like to suggest further study on the following additional issues:

- Consistent treatment of situations where historical data does not include a downturn period;

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[9] *Ibid.*
[10] *Ibid*, p. 201 (DOD Recommendation # 14).
[11] *Ibid.*, Chapter 2.2 (Default Rate Requirements)

- Weighting of data series to give more weight to certain periods; and
- Standards related to the use of rating agency, pooled and other types of external data.

Other than these issues, treatment of data gaps for low-default or low-data portfolios should preferably already be addressed, at least to some extent, at this stage. This is to avoid large discrepancies between bank's outcomes in the period preceding the further work outlined in section 4.5. As stated before, we would prefer this work to be undertaken in the context of the GL for PD estimation.

55 (iv) LGD Estimation

The IRTF supports harmonizing the weighting of default cases in LGD estimation, and recommends that LGD estimates should be default weighted.

57-59 (v) Downturn adjustment of LGD and conversion factor estimates

The IRTF recognizes the importance of a more harmonized definition of a "downturn" in LGD estimation. The IRTF refers to the IRTF Impact Sensitivity Analysis which shows that the diverse applications of downturn LGD, and differences in interpretations of downturn periods, and the selection of the technique to calculate a downturn add-on amounted to an estimated RWA impact of around 4%. Noteworthy is the gap of 11.3% between the lowest and highest LGD taking different data windows and downturn LGD methods[12]. However, it is worth noting, that not all observed portfolio LGDs are affected by a downturn, and when they are, the impact varies across portfolios.

We are aware that the EBA is currently working on a guidelines related to downturn LGD, and agree that this is much needed as existing guidance is ambiguous and leaves too much room for interpretation. Given the importance of this topic, we urge the EBA to seek full alignment with the BCBS, so that there is harmonization in the final guidance being provided. Ideally, the EBA guidance should not materially diverge from existing guidance in other regions on downturn LGD unless there is a global agreement on the way forward resulting in a revision of such other guidance.

On the discount rate, the IRTF notes that it is only mentioned in the DP in relation to the downturn LGD, however the findings of the IRTF Final Report and the Impact Sensitivity Analysis show that the development of uniform standards related to the choice of discount rates can materially reduce some of the RWA variability. GCD data shows that discount rates used by banks vary between 4% and 15%, and the two extremes yield an RWA difference of approximately 8%. Therefore, the IRTF recommends that the regulatory community imposes a uniform approach to discount rates. In the interim period, banks should be requested to report the discount rates used, how they are defined, and whether they are using a fixed or variable discount rate. It is also of paramount importance to determine what discount rates are supposed to represent.

[12] *Ibid.*, 1.5 Impact Sensitivity Analysis: LGD 17 and 18

Comments on Treatment of Defaulted Assets

62-69 General Comments

Although the treatment of defaulted assets and the calculation of ELBE are not discussed extensively in the IRTF report, the IRTF supports more clarification in the form of further guidance regarding the capital requirement for defaulted assets. The hypothetical examples in the IRTF report [13]show that the unexpected loss component (UL=LGD -/- ELBE) could lead to variance in RWA for defaulted exposures.

64-66 (i) IRB Shortfall

As previously indicated, global alignment of the rules on the calculation of the IRB shortfall is necessary to avoid misinterpretation in cross-border comparison, therefore we recommend the EBA wait until the final paper from the BCBS on ECL models is published and until the Basel AEG has opined on the EL shortfall computation going forward before issuing further guidelines.

Furthermore, we recommend the EBA to explore where US GAAP and IFRS might lead to different levels of provisions, in which case the EL shortfall calculations should neutralize this effect. In this context, we further note that there could be further discrepancies between the regulatory EL calculations and the ECL model outcomes that need to be evaluated; not only the different horizons, but also differences in exposure calculations and definitions of default (e.g. materiality threshold) can make this a complex issue that needs careful consideration.

The IRTF further notes that the interpretation of CCR Art. 159 imposed by the EBA might be unaligned with practices in other (non-EU) jurisdictions.

Comments on Scope of Application of the IRB Approach

72-77 General Comments

As outlined earlier in this response letter, differences in PPU and roll-out provisions can be dealt with by way of additional disclosure[14] if the issue is the lack of comparability. If however the EBA's main concern is related to the difference in supervisory practices, we note that for many large international banks lower roll out percentages are generally the result of local (non-EU) supervisors not having implemented Basel II/III or not yet allowing internal model approaches.

Comments on Internal Risk Management Processes

83-84 (ii) Use Test

The IRTF believes that the adherence to use test compliance is a crucial success factor of the IRB approach. Models enable senior management to measure, and adequately and timely manage, portfolio risks; senior management naturally requests to be informed at all times about (negative trends in) expected and unexpected losses and their effect on capital and profitability. The consequent misalignment of regulatory capital and economic drivers of Profit

[13] *Ibid.*, 1.5 Impact Sensitivity Analysis: LGD 19
[14] *Ibid.*, p. 269 (Table 6)

and Loss (P&L) is likely to lead to suboptimal risk management practices. Therefore, "gaming the system" does not provide a long-term benefit to firms.

It is important to mention that if the BCBS decides to implement new capital floors, depending on the form and calibration of such capital floors, this may create perverse incentives for business decisions that change product offering and pricing of financial products. Furthermore, firms may need to run separate models for internal and regulatory capital, increasing IT and risk management costs for all products. These use test breaches will complicate capital governance for banks and their supervisors.

85-86 (iii) Stress Tests (Art. 85-86)

The IRTF supports a full revaluation of the role and implementation of Pillar 2 and stress testing processes, both by banks in their ICAAP and by supervisors in their SREP. Inconsistent implementation of Pillar 2 goes against the objectives of a level playing field and of comparability and potentially hampers transparency. The role of Pillar 2 (especially given likely changes in Pillar 1 capital), the level of prescriptiveness of Pillar 2 (e.g. risk coverage, capital consequences), the interaction between Pillar 2 and Pillar 1, as well as between Pillar 2 and regulatory stress testing, also in the context of the overall goal of risk sensitivity are key components in today's debate on the future of the capital framework.

The IRTF strongly believes that Pillar 2 cannot correct for, mitigate or replace the loss of risk sensitivity in Pillar 1; on the contrary, in case capital floors or less risk sensitive measures are implemented at the Basel level in Pillar 1, the IRTF contests the view of some that Pillar 2 should in all cases lead to additional capital requirements.

Comments on Supervisory Convergence and Supervisory Consistency

111-115 (i) Convergence in supervisory practices

While the EBA RTS on assessment methodology of the IRB approach will contribute to harmonization of RWA, in the view of the IRTF a wide scope of RWA variability should be considered to achieve a fully satisfactory result. This is because many fundamental issues which have a material effect on RWA are not included in the scope of the RTS, and because the interaction between single RWA variance drivers is important. Also, seemingly small issues can have a potentially large impact on RWA. We refer to our comments on Section 4.2 of the DP outlining which issues need to be tackled at a minimum.

For this reason, the IRTF fully supports aiming for convergence in supervisory practices which is a crucial part of RWA variance. The use of national discretion should preferably be confined to the incorporation of specific local market, product or contextual features, and stop at particular supervisory preferences that are unrelated to the risks being captured.

Of special interest in this debate are issues which are listed in Section 4.5 of the DP. The IRTF believes that harmonization in these areas is a pre-requisite for better and true comparability and benchmarking producing results that unveil *true* outliers. In these areas, banks often act upon instructions by local regulators; these, while given for valid reasons, diverge between supervisors.

113 Pillar 2 SREP process use

The IRTF deems the RTS on the assessment methodology a necessary condition for convergence of supervisory practices even though this may not be sufficient on its own. Similar

to what is done in the context of the RCAP by the Basel Committee, some pressure to conform will contribute to this convergence. This point ties in with paragraph 113 of the CP which discusses the potential for some authorities to use the Pillar 2 SREP process to adjust internal model outcomes, while others use Pillar 1 requirements for the same purpose. The IRTF stresses the importance of harmonization of supervisory adjustments and supervisory imposed margins of prudence. This would be much preferred to a disclosure obligation explaining what choice the national authorities have made and how that impacts the consistency and comparability of RWA across different jurisdictions.

The IRTF does not believe the frequency of supervisory reviews has a material impact on RWA variance; as a general rule (as also outlined in the DP), models are reviewed at least on an annual basis and more frequent reviews are unlikely to affect RWA in any significant way. Without prejudice to the above, banks are mandatorily reviewing and revalidating models when a material model change is being implemented.

116-124 (ii) Benchmarking

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It is important to note that as much as a systematic underestimation by a bank, outliers can also be the result of a systematic *over*estimation by peer banks due to an accumulation of supervisory requirements; the supervisory intervention can for instance be associated with a local macro-prudential concern unrelated to the robustness of the model in question. Therefore, we reiterate our position that more capital is not necessarily a reflection of accurate capital, and that capital for certain portfolios being too much divorced from the actual risk and the bank's default and loss history might distort risk-based pricing and capital allocation, and as such can procure perverse incentives. The IRTF in this context also supports paragraph 123.

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The IRTF sees merit in requesting firms for information adjusted for supervisory imposed floors or other adjustments. However, depending on where in the process the adjustment is made, it will be rather challenging for banks to single out or separate all iterative margins of prudence or other adjustments. "Before and after" information is thus not always easily accessible or reporting thereof will create undue operational burdens. We would promote further discussion with the industry to narrow this down to workable processes.

The IRTF fully supports the EBA comments in Paragraph 124 on the appropriateness of corrective actions and retaining the dynamic nature of capital requirements. This is an essential advantage of a capital approach based on internal models.

Comments on Transparency and Supervisory Reporting

127-135 (i) Pillar 3 Disclosures

As can also be deduced from the emphasis the IRTF put on disclosure in its final report, the IRTF welcomes efforts to enhance transparency on individual banks' RWA and risk profile. The IRTF concurs with many of the elements listed in Paragraph 129.

However, global harmonization of disclosure tables and definitions is essential to achieving transparency and comparability. Peer benchmarking often is done between G-SIBs with operations across the globe. We hope that the EBA will feed into, and align with, the Pillar 3 and EDTF discussions. We also point to Chapter 3 of the IRTF Final Report outlining concrete

proposals to disclose relevant information which, contrary to some of the items contained in the revised BCBS Pillar 3 Phase 1 standards, does not have the drawback of distortive comparisons, and therefore allows for true comparability. A striking example of disclosure items that could be misinterpreted is the number of defaulted obligors in a context of high variability in the definition of default.

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In line with BCBS Pillar 3, we believe that, rather than uniformly imposing bi-annual disclosure of all items and Tables, it would be preferable to define for each template, on the basis of a cost-benefit analysis, what the frequency of disclosure should be. For some templates either the materiality of change or the relevance of the change for external stakeholders is low.

137 (ii) Ad hoc disclosures

The EBA proposes in Paragraph 137 to remedy the limitations of Pillar 3 due to a lack of harmonized definitions and modeling approaches by disclosing on the EBA website harmonized, "easy to access" information. The IRTF supports efforts to enhance overall transparency and therefore is not against further attempts to provide external stakeholders with standardized information. Nevertheless, the IRTF also has some reservations about the form such disclosures would take:

- It would be preferable to focus on the harmonization of modeling approaches and on getting Pillar 3 in the best shape possible rather than adding another disclosure paper. The latter may have to be reconciled to Pillar 3 to make it truly understood by investors;
- It will prove challenging for the EBA to fully adjust for the lack of harmonized definitions and modeling choices and therefore the standardized information might, inadvertently, contain inaccuracies; and
- Market discipline might result in the published metrics being used as a new standard to converge to for individual banks even if and when their risks are not fully comparable to those of their peer banks.

140-143 Disclosures of some elements in relation to benchmarking

The IRTF wishes for the EBA to clarify whether its intention is indeed to disclose the results of future benchmarking exercises on a name by name basis ('compare model outcomes in different institutions'; 'some institutions have already disclosed their positioning in previous benchmarking exercises in their Pillar 3 reports'). IRTF banks are not comfortable with this idea for the following reasons:

- HPE or other benchmarking exercises can never fully mirror real bank portfolios and portfolio concentrations; in low-default portfolios, real transactions undergo lengthy tailor-made credit approval procedures and in retail portfolios, local market differences must be accounted for to achieve true comparability.
- Solutions to overcome these shortcomings such as the creation of comparable clusters or back-testing model results outside the individual model context create new realities that may in some cases prove too divorced from a bank's true portfolio and model.
- Also, HPE exercises inevitably embed operational risk. Analysis by GARP demonstrated the relevance of operational errors if transactions are not routed through normal procedures with the appropriate checks and balances, but performed in a manual spreadsheet exercise.

- As indicated in the IRTF report, as long as risk sensitivity remains a shared objective, there will always remain justified variability. The publication of benchmarking results could prove counterproductive as banks would strive to be close to the mean even if the portfolio requires a different outcome.
- Therefore, it could easily create pseudo comparability and outlier banks could be unduly penalized.

155 On "desirability" of diversity

The IRTF agrees with the EBA that diversity is desirable. This diversity should not just stem from differences in risk profile and market strategies, but equally from:

- Differences in risk policies and the quality of risk management: for instance, successful recovery and account management practices should remain reflected in LGDs and EADs.
- Some differences in views on clients' creditworthiness; a single imposed view might prove inaccurate. The statistical data part of models generally is supplemented by a vital layer of expert judgment.
- Differences in the bank-client relationship: banks tend to have fewer defaults on their retail portfolios if the retail customers hold their main wage account with the bank.

Comments on Low Default Portfolios

157-178 General Comments

The issues related to Low Default Portfolios are complex and all angles need to be extensively analyzed and discussed. The IRTF stands ready to engage in a debate with the EBA to resolve perceived shortcomings in current model approaches and achieve harmonization where needed. The IRTF is considering undertaking some further analysis in this area which will be shared with the EBA at a later stage.

Comments on Philosophy of the rating models

175-178 General Comments

We commend the EBA for its initiative to tackle the important issue of "philosophy of rating models." However, we note that the DP appears to be discussing the Point-in-Time (PIT) and Through-the-cycle (TTC) issue as one only related to rating models. Therefore, we reiterate our main IRTF findings and recommendations below.

Firstly, that banks have different approaches to quantifying pooled PD depending on a bank's rating philosophy. Banks self-identify as PIT, TTC, or hybrid, but these terms have different meanings across the industry. Broadly, we agree that PIT systems attempt to produce ratings which are more responsive to changes in current business conditions, whereas TTC attempts to produce ordinal rankings of obligors that tend to remain the same over a business cycle. In reality, the majority of banks has systems that fall somewhere in between the PIT and TTC spectrum, and may exhibit characteristics of both. A clear agreement on terminology is therefore essential to reduce confusion. The EBA analysis should incorporate discussions on (i) the precise definition of TTC and PIT, (ii) the fact that TTC does not necessarily equate to having long-run averages and (iii) whether we are talking about rating or PD models or both

when evaluating the topic of PIT and TTC (in this regard our findings indicate that banks may have ratings, PDs of rating grades, or PD models with different philosophies, e.g. a bank may self-identify as having ratings that are PIT, while the PD of rating grades are more TTC).

Secondly, prior to any discussion, a clear signal should be given by regulators to banks as to how volatile or stable they wish bank regulatory capital to be. This is a key debate, not just for model development, but also for risk and capital management more broadly. Banks should strike the right balance between (i) promptly receiving signals of changes in risk profile or impending idiosyncratic or systemic problems, and (ii) having stable capital reserves and providing longer term incentives to the business; this influences their choice of rating philosophy.

Thirdly, there needs to be further explanation provided as to what constitutes a cycle, and against what time horizon a TTC rating model should be modeled.

Fourthly, the approach to the PIT-TTC debate should take account of, or be conformed to, the treatment of EL shortfall deduction. Anchoring the EL shortfall deduction to a common view of EL (with a clear view of what a "cycle" is) would help smooth out the differences in PIT-TTC philosophy.

Fifthly, given that the majority of banks have a hybrid approach, there need to be guidelines for the definition of hybrid, and how to construct a hybrid model.

We are not necessarily in favor of full harmonization, as long as clear guidelines and definitions are provided and internal benchmarking takes the TTC-PIT differences into account. Given the importance of this debate, we stand ready to engage with the EBA to resolve perceived shortcomings in current model approaches and achieve harmonization where needed.

The IRTF is considering undertaking further analysis in this area to be provided at a later stage.

Comments on Downturn Conditions

182-183 General Comments

As outlined in the recommendations section of the IRTF Final report[15] the IRTF welcomes clarification and harmonization of terminology and requirements. However, as stated above, the IRTF emphasizes the importance of a global approach. The difference in downturn approaches in both LGD and EAD are potentially material and regional guidance which is unaligned could create a new, undesirable driver of RWA variance.

Comments on Credit Risk Mitigation

184 Double Default Formula

While not treating the topic extensively during the IRTF project, it became clear that depending on the bank's business model, double default is an area that is important to many banks.

Apart from the part that we do not deem the double default formula overly complex, we believe that risk mitigation, hedging and risk spreading should not be unduly dis-incentivized.

[15] *Ibid.*, Chapter 1.3, Section 5, p. 133-135

In order not to create for the banks that make use of the double default possibility, a misalignment between internal and regulatory capital (and thus to breach the use test), we advocate that all banks will retain the possibility to apply the Basel double default formula.