EACB Comments

BCBS Consultative document

Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches

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INTRODUCTION

The members of the EACB welcome the opportunity to comment on the Committee proposal on constraints to the use of internal models (IRB) for the calculation of capital requirements for credit risk.

However, cooperative banks and mutuals have serious concerns about the Committee's proposals.

All in all, the considered changes are manifold and the effects will be profound. Many of the effects are in our view not yet estimated properly. We will provide examples here below. And even for those effects that have been studied/ will be estimated in the QIS, several will clearly not be intended. Therefore we ask for consideration for the numerous concerns expressed and also for more time to debate these issues and to consider alternatives.

The aim of the BCBS for improved transparency and comparability seem understandable in principle. However, in this context other regulatory initiatives should also be considered, given their similar goal.

Increased comparability cannot prevail over risk sensitivity, IRB is still efficient for risk management and steering of credit risk, including within some of those retail portfolios. In addition, some of the proposals with regard to input floors are far too blunt an instrument with which to address variability or comparability concerns.

As they stand the proposals would almost inevitably lead to increased capital requirements in the system and in many jurisdictions could, with respect to retail markets in particular, have significant negative impacts on the consumer and a detrimental impact on the stability of the financial system.

It is of the utmost importance that targeted sectoral and regional analysis of impacts are performed, with the largest possible involvement of the industry.

The Committee should grant national discretion to allow IRB for jurisdictions where there is strong evidence of robust modelling approaches built on solid data foundations.

OVERVIEW

The Committee has concluded, based on the experience of the crisis and a number of studies, that the IRB modelling choices have led to a too wide variance in the own funds requirements. The consultation proposal should thus address higher transparency, improved comparability, and reduction of variability in risk weighted assets.

However, the drivers that underpin the Committee's choice of measures to repair IRB reveal important criticalities.

- The proposed way forward following the review seems to be a step backwards and a fundamental shift in the philosophy compared to the elements introduced in Basel II, which represented a key moment to increase institutions' ability to assess risk and develop risk sensitivity. The proposed approach is a full "U turn" of the regulatory framework. For significant portfolios the risk sensitive internal approaches shall be replaced by a pre-Basel 2 one size fits all approach. The advancements of Basel II have been integrated in the risk management and capital planning and only now can be fully assessed. Lack of risk sensitivity will likely lead to the inappropriate pricing of risk, less lending in low-risk asset classes, less diversification across banks' portfolios, a shift of risks to the unregulated sector and a corresponding increase in risk to the financial system as a whole. We do not believe that the proposals of the Committee are the appropriate solution to fix the internal models.
- Given the pending decisions on the finalisation of the Standardised Approach (SA) framework, and the proposed shift of relevant portfolios under such approach, we have serious doubts on whether it can be ensured that no significant increase of capital requirements is generated. We also have doubts that the proposal will actually lead to a reduction of the variability of risk weighted assets (RWAs). Already the current impact analyses and interim QIS and ad hoc exercise figures show the potential for vast increases in capital requirements. We also have no comfort with regard to the consequences of combined impacts for portfolios' and changing conditions for competition. In addition, flooring low risk exposures does not increase transparency or comparability, if a more punctual work on high risks is not performed. The measures specified by the Committee should not be decoupled from supervisory and regulatory actions in various jurisdictions, which are particularly important in ensuring that the specific nature of individual national markets is considered and catered for via appropriate local regulators' discretion, or from a consistent approach to internal management across Pillars.
- Moreover, to respond to the intention of avoiding significant capital increases, the interaction with TLAC and its calibration level should be considered. Analogously, regulators and supervisors should take a joint perspective on the overall levels of capitals. Imposing floors and pushing for higher Pillar 1 requirements should have reflections on the Pillar 2 strategy of supervisors. A further strengthening of Pillar 1 requirements cannot be coupled with unchanged Pillar 2 add-ons.
- Furthermore, the overall timeline proposed by the Committee seems too short to address such a far reaching subject. The consultation period does not allow the formulation of comprehensive alternatives by institutions and the QIS itself will reveal

extremely challenging to be properly completed, bearing the risk of not delivering the amount and quality of information that would be needed.

- Finally, we strongly believe that, in addition to the global QIS exercise, targeted sectoral (SME, agricultural, corporate) and regional analysis of impacts should be performed, with the largest possible involvement of the industry. This should also be seen in the context of the presence of fundamentally different banking business models at global level: on the one hand a much disintermediated financial sector on the other a more intermediated one in Europe with several universal and cooperative banks using very sophisticated internal models, for which impacts are way more far reaching.
- Lastly, we believe that outreach events involving the entirety of the industry, as done for the proposals on the Standardised Approach to which the EACB actively participated and contributed, should have been envisaged.

ISSUES ON THE PROPOSAL'S OVERALL DESIGN

- *Excessive complexity of the regulatory framework, inconsistencies in accounting approach, regulatory capital and own risk assessments*

Basel II followed the principle that users of IRB would establish adequate internal models systems and processes and, based on this, draw a far reaching and comprehensive picture of relevant risk drivers. This led to fundamental progress in risk estimation and understanding across the financial industry.

Repealing internal models may lead to a reduction of complexity in Pillar 1 capital requirements calculation, but it would discourage further development of internal models for risk management purposes. In the long run this may weaken the stability of financial institutions and markets

In addition, any proposal should be put in context with the wider scope of the regulatory agenda, especially accounting developments, such as Expected Lifetime Loss provisioning under IFRS 9. To this end institutions will have to run internal models also for those portfolios which would now be removed from IRB treatment. Those models would have an impact on capital accounts via portfolio provisioning. Regulators and supervisors will have to assess the adequacy of such models in any case, thus no relief would be provided in terms of administrative burden. We might even witness a further drifting apart of regulatory and accounting views.

The vast number of regulatory developments of the past years has already led to an extensive high quality framework for banks, with which they operate and which provides reliable process. In addition, the ongoing and planned regulatory and supervisory projects (e.g. by the EBA, the ECB etc.) would strengthen this process further.

Scrapping the IRB approach, which has become a major risk management tool, for entire risk exposures categories seems overzealous and very counterproductive.

Especially where there is a long history of data upon which to build robust models, the shift may trigger significant detrimental impacts on capital requirements, along with potentially very harmful consequences for consumer choice and the wider market. At the very least the Committee should consider allowing national regulators the discretion to retain IRB for those portfolios where a modelling approach is evidentially both sensible and conducive to good risk management.

This drastic move should be carefully assessed in all its consequences, such as reduced incentives for accurate risk measurement, excessive risk taking, shift of significant parts of lending towards the shadow bank system, increased lending cost (e.g. for the commercial real estate sector and specialised lending). All of this, as recalled above, over a time line that is by far not adequate to achieve the intended results.

- *Availability of data – Quantity and quality of relevant information for risks and portfolios*

Relevant challenges for the introduction of IRB, in the wake of their development, were the lack of meaningful data on default and loss experience especially in the areas of low default portfolios (LDPs). The systematic and targeted development of internal data collection and the use of internal information have led to the establishment of significantly robust basis. Moreover, the pooling of information and certain activities by different credit institutions in some countries has represented an additional response to the scarcity of data. We believe that such (anonymised) data pooling techniques are to be explored further, in cooperation and with the consent of supervisors.

A general obligation for the use of the SA in the area of LDPs cannot be justified by the simple generalised opinion that there is a lack of default history. Given differences in market sizes, in individual banks' portfolios' size, and possibilities to pool data, this cannot be taken as a correct conclusion. We argue rather that the introduction of minimum requirements for "usable" information and modelling of data, and where necessary stricter rules, are instead more appropriate. A fundamental IRB abandoning is not the answer.

- *Excessive variance in regulatory requirements*

One aim of the Committee is to reduce variance in capital requirements. The proposal intends to lead to a reduction of complexity and variety of different approaches. However, this would also imply retreating to the less risk sensitive SA. Moving in this direction for the purpose of reducing complexity is clearly inappropriate and ineffective. Risk sensitivity and scrutinising (and even accepting when well justified) outliers should be a primal aim, rather than comparability.

The risk sensitivity and complexity of the IRB approach is actually one of the best instruments available, and the SA can reflect different risk profiles only to a certain extent. The move towards the SA for IRB banks could induce a shift towards riskier transactions, paradoxically penalising low risk exposures the most via floors/FIRB. This can result in adverse selection in portfolios, and this surely cannot be an intended outcome.

Moreover, it would be better to take actions based on the targeted review being conducted for instance by the ECB (Targeted Review of Internal Models or TRIM project). The ECB case-by-case assessment could bring advanced and more conclusive basis for decisions. Supervisors have built up the capacity and the expertise to reduce excess variation in risk weighted assets using the tools at hand. Removing some portfolios from IRB treatment is a dramatic short cut.

In this respect, information from the EBA indicates that acting at a definition level would be a much more effective solution, for instance differing definitions of default already explain large parts of RWAs' variability.

The variability for the IRB exposures that are not floored, stemming from the usage of diverse methodologies, assumptions and multiple interpretations of definitions will remain. Addressing these issues via focused harmonisation of certain aspects of IRB would address the variability in risk weighted assets directly.

Further understanding of the variance in regulatory requirements could also be better understood by other mechanisms such as via the publication of benchmarking data, whereby the range of internally modelled regulatory requirements by risk level within portfolios are disclosed, facilitating comparability without compromising the advantages that robust models give to good risk management practise.

While a solid capital buffer for the purposes of increased prudence offers added value, as providers of capital can see that the banks are more solid, increasing capital demands based on more strict non risk sensitive standards/floors may have a converse effect on confidence. In effect, the supervisory authority and regulators state that the buffer is not great enough for the risks that are run. Although at the same time it is claimed that the total level of capital in the system is sufficient and should remain the same. We should beware that discussions on internal models do not result in a self-amplifying reality of loss of confidence in banks: although nothing has changed in the real economy, nor in the banks' credit portfolio, it would nevertheless appear as though the capitalisation of banks has suddenly deteriorated. However, the current proposals relate to very general measures that are imposed on an entire sector and do not adequately relate to the development of the underlying risk. Our point of view is that capital standards need to be differentiated to risk level, based on risk sensitive and calibrated models.

➢ *Lack of information advantage for the market is not the full story*

The BCBS argues that there is a lack of information advantage for the market with regard to certain portfolios under the IRB. While we concur that there is important information already available for some exposure classes, the IRB has important (allocation) advantages:

- Robust estimation of credit risk requires the use of all sources of information. This includes on one side market information on transactions or borrowers. However, individual analysis (e.g. the development of a specific market) are also crucial in the estimation process. This also creates the possibility of creating a competitive advantage in the use of information, that represents an important incentive for the development of reliable risk estimation assessments.
- The use of internal processes and models allows swift reaction to changing risk profiles at short notice. In case of deterioration of the borrowers' financial situation, risk can be increased due to internally available information. A strong monitoring is usually devoted on important borrowers such as large corporates or financial institutions. Risk signals can be immediately translated in a decrease of the rating, while the rating process for rating agencies is delayed by lags in the availability of information and also to avoid potentially self-amplifying effects of downgrades following early risk flags. We believe that close monitoring of customers allows the IRB to react faster to idiosyncratic risks, especially for decreasing ratings, allowing also to respond faster with higher capital allocations.
- In particular, for specialised lending transactions we do not share the presumption of better information available on the market rather than internally to institutions. Banks receive much more detailed information on these deals and can use it efficiently in assigning ratings.

- *BCBS consultation does not recognise other regulatory workstreams that have been initiated to improve the overall quality of internal models*

In the past years both industry and supervisors made significant investments in order on one side to be able to build and validate prudent models and on the other side to verify the adequacy of such models and grant approvals. We believe that significant progress has been made, also in the area of low default portfolios, and that supervisory bodies have built up the capacity and the expertise to sufficiently reduce excess variation in RWAs using the tools at hand. It is our understanding that efforts on the European level – EBA harmonisation of definitions and ECB Targeted Review of Internal Models – aim to do precisely that: to harmonize supervisory and industry practice with the objective to remove excess variation in capital and along the way assure high quality risk measurement within the industry. This is in our view on the other hand of the spectrum of possible actions compared to the proposed short cut of simply removing some portfolios from IRB treatment.

Firstly, the ECB launched its TRIM for a detailed assessments of models used in the SSM area which, over 2016, focuses on governance and methodologies. The ECB has similar goals as the ones indicated by the Committee. The TRIM is designed to:

1) Re-establish trust and adequacy of AIRB models by ensuring that capital reflects the underlying risks;
2) Promote comparability and improve model quality;
3) Promote a level playing field and a sounder prudential treatment.

In case of deficiencies, appropriate measures are taken which directly improve the quality of the models (model redevelopment, data cleaning points, add-ons in case of underestimations etc.). These actions directly address and improve the actual risk measurement, which is more effective than applying floors and restrictions.

Secondly, also the EBA has launched initiatives for addressing areas of the IRB where improved consistency is needed and can be achieved (definition of default, PD and LGD estimation etc.). It was observed during (benchmark) analyses that fundamental aspects such as definitions and methodologies were not aligned among banks. Up to this point the EBA already published consultation papers on the materiality threshold/counting days past due and the definition of default. This year guidelines will be published for PD/LGD modelling and defaulted assets. These quick wins should be more broadly supported as they directly address the issues on which the Committee intends to act. We believe that the IRB framework should receive a fair chance to manifest itself rather than deconstructing the framework without receiving the opportunity to prove itself.

Moreover, authorised IRB banks and models have to comply with intensive validation procedures and any change has to be communicated to supervisors. Depending on the scope of changes additional supervisory verification will be required. Also, the models are assessed on a yearly basis by banks' internal audit functions.

Advanced modelling introduced with the Basel II framework (despite its imperfections) resulted in a more detailed and granular risk management methodology at banks. Estimating PDs and LGDs forces the bank to systematically explore clients' balance sheet, ratios and find statistically significant risk drivers. We feel that this development has benefited financial markets. High quality standards and comparability are to be expected; and if some inconsistencies in capital allocations for the same risk emerge that cannot be explained after due diligence, the capital calculations can be optimised rather than scrapping an entire approach to risk management and modelling for such portfolios.

- *The BCBS proposal in the context of the regulatory framework and bank management*

From an internal risk management perspective the proposal of the Committee does not seem consistent or conclusive. Recent measures such as the SREP add-ons in the EU go in the direction of assigning increased relevance to integration between Pillar 1 and risk management.

This is an incentive for banks to shape their IRB in a way that is appropriate to respond also to supervisory expectations. The proposed changes rather lead to differing risk views between Pillar 1 and Pillar 2, providing wrong incentives for internal management.

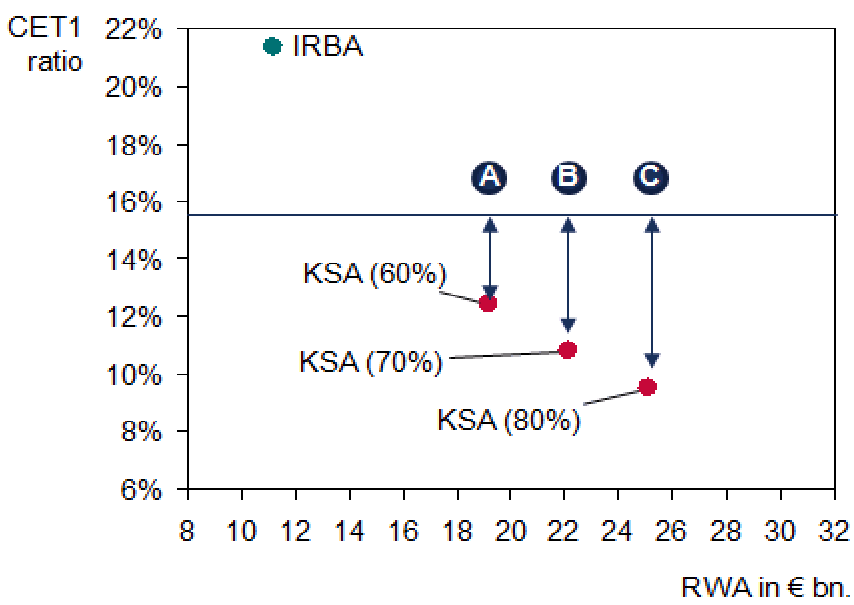
- *Increased capital requirements*

It should be expected that the proposal will lead to considerable RWAs increase, and a reduction of CET1, despite the intention not to significantly increase capital requirements. For instance, the impact is substantially noticeable just mentioning specialised lending transactions, for which the RWs increases are not coherent with the low loss rates observed on those financings. However, capital increases should be justified only if default risk is actually under estimated. It would be extremely difficult for banks to explain such drastic changes to clients.

In addition, capital increases may arise also for exposure classes that will remain in the scope of IRB depending on the definition of floors. In case of a strictly calibrated floor the misincentives of Basel I may materialise again soon. For example, in order to offset the need for more capital, banks will shift balance sheets towards riskier and higher yield exposures while it could become more difficult for "good" risks to receive appropriate terms for lending and rating. This could particularly be the case for specialised credit institutions with low default portfolios (LDPs), as their risk and return mix (assumed in the SA as basis for the floors) is more hardly prone to diversification.

Here below, we report a stylised impact analysis from one of our Member institutions with a business focused on low risk retail portfolios. The current capital ratio is at nearly 22%, the red dots indicate how three scenario floors (60, 70, 80% of SA) would affect the capital position of the institution.

Impact Analysis „Capital Floor“



In addition, when banks rely a lot on collateral (e.g. physical collateral and also real estate and receivables), given the LGD floors on the secured part of the exposure that would result in overcollateralization, the floor has a significant impact on capital requirements, in particular with respect to financing the agricultural sector which is very often a central element of the real economy financed by cooperative banks.

With respect to secured, retail mortgages (both residential owner-occupier and residential retail IPRE) the proposed LGD floors are a very blunt instrument to managing potential underestimation risk particularly at the low LTV end. While some underestimation risk may materialise *on average* at low LTVs, and some sort of flooring may be appropriate, the proposal is not sufficiently sensible. A tiered approach looking at clusters of LTV leading to a final floor would be be a more sensible option. There is also insufficient rationale for the proposed level of the LGD floor within the consultation.

Large impact is to be expected in Corporates and specialised lending (including commercial real estate).

The impact would derive both from the restrictive use (foundation approach/SA) as well as the input floors, that should not be underestimated. In particular, portfolios that are reliant on physical collateral such as TCF, leasing but also rural exposures will be affected by the LGD/collateral input floor, while exposures to banks would be affected to a lesser degree. Also, taking into account the proposals for a review of the SA it has to be expected that the output floor will have a large impact on mortgages.

The measures will have a substantial effect on banks and on their role in provision of financing to the economy. Making credit intermediation by banks less attractive also contradicts the stance taken by Central Banks to increase the liquidity in the market. Furthermore, non-bank institutions are not governed by the same capital requirements and supervision and they will gain an unfair competitive advantage in the financing landscape. This will not be beneficial to the continuity of financial institutions, and it will also not be helpful for stability and for the economy at large.

Due to the increase of capital cost, pushed by steeper requirements, direct implications for loan provision and restrictions to lending are likely to materialise. While there might be some relief from the cost intensive procedure and processes for risk management, reduced data quality would make it more difficult to respond to risk changes and maintain current pricing for customers. In their current form the proposals will create new risks, increase costs and they may put a strain on economic growth. A greater capital pressure on banks can result in the loss of opportunities for growth in the economy. Furthermore, we believe that these proposals will lead to risk selection and arbitrage, and that this will actually increase the complexity of the credit intermediation system.

Regarding the output floor, it feels too early to be setting out how an output floor would be calibrated, given that there are still so many parts of the capital framework which are under development.

FOCUSED TECHNICAL ASPECTS

➢ *IRB proposals will disproportionally impact agri lending*

Agricultural lending is by and large secured lending with agri land/buildings and crops/seed/agri chemicals as collateral. The security is perfected in a mortgage (on land/buildings) or a pledge (on crops/seeds/agri chemicals). Banks have specialized departments to finance farmers. The underwriting criteria are more conservative than applied in commercial/residential real estate financing, with more moderate Loan to Values. The portfolios have performed very well historically compared to non-agri portfolios. Multi-year historic Impairments are low. The reason for the strong performance is that in a worst case liquidation scenario, agri land/buildings as well as crops/seed/agri chemicals are sold with relative ease (often to a neighbour farm). High collateralization coverage levels are a specific characteristic in this market resulting in low observed losses. With the new proposals on the LGD floors, the capital requirements will be increased. The underlying collateral will have a diminishing effect which in result penalizes well-collateralised exposures.

In agri financing, the collateral for the financing consists for example of the farmland or the machinery and the market value of the agrarian produce. In addition, major business loans involve the monitoring of lines of credit, covenants and the formation of special teams to control risks. If this is not recognized in full, it will lead to the adoption of excessively high capital standards, to unnecessary restrictions and to increased costs.

The importance of the agricultural sector for the economy is beyond doubt and there is no reason to doubt the quality of collateral used in the F&A sector. The proposed rules would result in much greater capital reserves than the customary reserves currently held in the market and will greatly exceed the reserves needed to absorb the actual losses on the agri portfolios. The rules will also impact loans to major businesses, financial institutions, specialised lending, goods financing and leasing. The proposals are disproportionate to the intended objective and we would rather draw attention to the importance of the further improvement of the internal models, including the adoption of more stringent criteria. The combined impact of new SA rules, the possible introduction of floors and the constraints on IRB models could in addition seriously impact the mortgage portfolio's, for which capital reservations are very much based on the value of collateral.

The EACB member banks can each demonstrate performance of the sector with many years of data. The proposed LGD floors and accompanying haircuts on the secured part (15-20%) is harmful for agri lending. Instead, banks with sufficient and reliable default data, should continue to be able to make risk assessments based on several years of history taking into account a complete agri sector cycle.

As well for the health of the sector, as for keeping the quality of agri finance at high level, we would suggest to maintain the AIRB without the LGD floor restrictions and the predefined haircuts on collateral when sufficient data is available.

➢ *Specialized Lending activities*

There is a strong concern for Specialized Lending activities regarding the new proposals brought forward by Basel Committee on Banking Supervision with the proposed removal of internal models, to be replaced by either the revised Standardized Approach (which would also apply as a floor) or the Slotting Approach. Both proposals would not be risk sensitive enough for this bespoke type of financing and their calibration is overly punitive compared to the low loss rates observed.

Structurally speaking, Specialized Lending benefits from the following characteristics:

- Control over the financed asset or the project financed and over cash flows generated, provided by the legal documentation structure, and by the security package which comprises of security over the assets and/or pledge over the shares of the borrowing structure, general assignment of earnings and specific assignment of contracts and insurances, limitation imposed on the borrowing structure in terms of activity, additional indebtedness, new investments, etc.
- Assets financed relate to large transportation, social, electricity and energy infrastructures, natural resources plants, aircrafts, vessels, railway networks, real estate or commodities, which are critical to real economy, and which benefit from underlying sustainable cash flows.

These structures and security packages, together with the experience of dedicated teams, enable lenders to monitor the risk of these deals and benefit from low loss rates. Those financings require risk sensitive approaches, hence internal models are the best way to adequately allocate banks capital.

These financings are key strategic to the economy, given amounts at stake and the nature of financed assets which are large infrastructure and commodities. The impact of commercial banks providing lower volumes of financing to these activities would be very detrimental to the development and renewal of critical infrastructures assets.

1) *The current BCBS proposals are not consistent with the low loss rates observed on those financings and instead we propose that internal models be kept subject to some conditions.*

Knowing the importance of default and loss data, banks have pooled their data on Specialized Lending, except for IPRE. Hereunder are the loss rates calculated on the basis of pooled data provided by Global Credit Data and S&P:

	Observed Default Frequency (ODF)	**Observed LGD**	**Expected Loss Rate*** (ODF x LGD)
Aircraft finance	1,96%	16%*	0,31%*
Shipping finance	3,13%	13%*	0,41%*
Commodities finance	0,89%	13,30%	0,12%
Project finance	1,50%	23%	0,35%

**Sources: 1*

Specialized Lending expected loss rates are around 0.15-0.40 %, i.e. much lower than for unsecured corporate loans.

Regarding IPRE, despite the absence of recent reliable pooled data at European level, worth to note that according to a March 2013 Bankers Association Research Datanotes2 in which an analysis was conducted on various real estate loans categories (single family, commercial and industrial loans, CRE loans…) from 2007 to 2012, the conclusion was the following "Over the course of 2012, and throughout the credit crunch and recession, commercial and multifamily mortgages have had the lowest charge-off rates of any type of loan held by commercial banks and thrifts."

⇨ Proposed RW do not recognize the secured nature of SL and low loss rates observed

Although not directly comparable, implied Risk Weights that would result from historical loss data, have been computed and compared to the proposed RW under the SA or Slotting approach proposals:

[1]

- Aircraft, Shipping: source Global Credit Data
- Commodities Finance: source AFME Discussion Paper, Capital Treatment of Commodity Finance, December 2015
- Project Finance: source S&P (Discounting at loan rate)

* 5 % conservatively added to the LGD in order to have an equivalent of discounting at loan rate
NB: GCD data include both senior and junior loans

[2] See http://mba.informz.net/MBA/data/images/cmfdatanote030513.pdf

	Implied RW *	SA proposal	SA proposal/ Implied RW	Slotting approach **/Implied RW
Aircraft finance	55%	120%	2.2x	2.0
Shipping finance	50%	120%	2.4x	2.2x
Commodities finance	33%	120%	3.6x	2.9x
Project finance	75%	150% ; 100%	2x, 1,3x	1,5x

**These implied RW are based on average default and loss rates observed on pooled data.*

***we made an estimation of the Slotting criteria RW[3] which is a best effort and only indicative as this approach is not applied by IRBA banks, and we don't have a consistent view on the breakdown of the portfolio in the different categories.*

As shown in the table above, current proposed risk weights under the Standardised Approach or the Slotting Approach seem unduly conservative. The secured nature of these financings (through comprehensive security package) by valuable assets and cash flows is not taken into account by current proposals.

⇨ Proposal of keeping internal models by addressing the data concern and variability issue, subject to a number of conditions.

The BCBS concern regarding the lack of historical data and variability of RW could be addressed through the enrichment of data pooling with additional information. Banks would agree on a set of relevant additional type of information to be collected for each type of Specialized Lending exposure. These data would enable banks to input the defaulted deals (even though these were not originally in their portfolio) in their internal models and check that those ones provide consistent estimates of loss rate observed. This would enlarge the back testing which today is processed by each bank on the basis of its own default data.

As long as internal models provide consistent loss rates estimate, also reflecting the bank's strong risk management, they should be kept. This could be done subject to a number of conditions to be fulfilled:

- Appropriate organisation of origination and monitoring teams so as to ensure that experience of and lessons learned from deals in difficulty is shared

[3] Slotting criteria RW estimated with the following assumptions:

- a maturity over 2.5 years for Object Finance and Project Finance and 1 year for Commodities Finance,
- 70% of the portfolio[3] would be in category 1 or 2 and bear 70% or 90% (ie 80% in average), and 30% of the portfolio would be in category 3 or 4 and bear 115% or 250%, (ie 183% in average).
  This would imply an average Slotting approach RW of 111% for Object Finance or Project Finance and 97% for Commodities Finance.

- Lending policy periodically updated in consideration for Default track-record and taking into account the evolution of markets.

2) If kept as an alternative, the Slotting approach would need to be reconsidered.

Should Slotting approach be considered as a possible alternative, it would then need to be revised:

- The current supervisory slotting approach will lead to a lack of risk-sensitivity. Many operations with very different characteristics will be treated with the same level of risk. Therefore, it should be much more granular, notably in categories 1 and 2 in which most of the exposures would be concentrated.

It should be calibrated at a level consistent with historical loss observed on SL (please see also in appendix harmonization of internal models proposal that could be used for Slotting approach calibration as well).

➢ *Specialised lending and Income Producing Real Estate (IPRE)*

Another area where of fundamental distance with the proposal regards income producing real estate (IPRE) exposures (see paragraph of section 2.2. of the CP). The BCBS suggests "*to remove IRB approaches for specialised lending*" in respect of income producing residential real estate (IP-RRE – a subset of IPRE, within specialised lending). Looking at the BCBS's own criteria for modellability set out in Table 1, IP-RRE scores high on all three criteria at least in various EU jurisdictions (e.g. UK, Denmark). The quantity and quality of relevant data are good, as this is a well established market with good data capture, and an adequate run of historical experience that shows low arrears and loss levels. There is an information advantage, as each IRB institution will have up to date detailed loan level data that gives specific knowledge of the detailed risks that institutions may be running, which is not available at that level of granularity to the market at large; and the robust and generally accepted modelling techniques are also well established and thoroughly reviewed and tested by the competent supervisors as part of the granting of the IRB permission, and periodically thereafter. We therefore see no evidence to support withdrawing modelling from the IP-RRE asset subclass, and oppose this proposal. If the BCBS feels it has to cater for specific jurisdictions where circumstances are different, this should be done by way of a leeway for supervisors: i.e. the competent authority could have the option to withdraw modelling from IP-RRE based on a local assessment of the table 1 criteria.

IPRE can be characterised by a high correlation between PD and LGD. However, many banks have abundant data on various segments of income producing real estate, including default data, and a long track record of approved estimation techniques for PD and LGD. The significant amount of data makes it possible to take account of the potential correlation between PD and LGD. We would propose to maintain AIRB models for these portfolios rather than applying the slotting criteria. The RWAs for the proposed slotting approach are calibrated too conservatively overall when compared to RWA determined by the AIRB parameters. The AIRB parameters can be supported via model back tests and the excessive conservatism will become apparent in the QIS exercises.

We find that the concept of specialised lending is ill fitted and should not apply to homogenous and common residential or commercial real estate exposures where abundant and reliable data is available, even when the lending shares some of the criteria for specialised lending. The specialised lending approach for income producing real estate should be reserved to financing real estate constructed for more distinct income producing purposes where bespoke lending conditions, including control features, are the norm, and where the IRB approach should not be used mainly because of lack of homogenous data and a bad loss history.

With this in mind we have noticed a significant difference between the specialised lending definition under the current IRB approach and the suggested specialised lending categories under the revised standardized approach, where it seems that the four defining requirements for specialised lending mentioned in Basel II seems to be missing from the definition of the two new specialised lending categories under the real estate category.

- *Banks and financial institutions portfolio*

Members have reported that the suppression of IRB for banks and other FIs will translate in very large impacts for this category of exposures (see also table above).

The proposal imposes the application of the SA. However, we see at least two reasons of concern: on the one hand the revised SA is introducing in addition to external ratings high level concepts of 'due diligence' and 'capacity to meet a financial commitment' to assess the applicable RWs, thus introducing a variability of RWAs that seems quite difficult to assess (while internal models still require supervisory approval).

In addition, the Committee sees that the application of the SA to these counterparties should be justified due to being "*usually highly rated by credit rating agencies*" and "*subject to significant market analysis*". However, in the current market conditions a large cluster of institutions is rated BBB, this would represent an incredibly steep increase of capital requirements.

We also see a conceptual problem with the definition of financial institutions provided by the Committee. In this proposal the BCBS assimilates Insurance companies to financial institutions, creating a discrepancy between the IRB and the SA, where they are considered as corporate exposures.

- *Identified limitation of proposed methodologies or model changes:*

We see that the proposal also implies a generalised switch to a Through-the-cycle rating system philosophy from Point-in-time approach for many institutions, in particular when indicating that "*Rating systems should be designed in such a way that assignments to rating categories generally remain stable over time and throughout business cycles. Migration from one category to another should generally be due to idiosyncratic or industry-specific changes rather than due to business cycles.*" Where institutions do not already apply a TTC, this switch would imply regulatory-related actions such as application for material changes of IRB systems, and major impacts on the retail risk management infrastructure and processes where the point-in-time rating grades and estimates are used in automated underwriting processes, credit policies, customer retention and acquisition, collection and overall portfolio steering.

The option should remain available for the Banks to choose which of the rating philosophies to follow, as this choice affects daily risk management.

A further consequence of generally moving banks that are not already on TTC to use the through-the-cycle approaches (apart from the significant development burden such a move would impose on lenders using point-in-time or hybrid approaches) is that there would need to be consistency between the different areas of focus within the same regulatory body to avoid unintended "double counting" of capital requirements, particularly in a stress, and possibly consider the calibration of buffers.

It should also be clarified what the minimum weighting approach of data for the modelling of the PD implies. We understand that the average period should be at least 10 years whereby the downturn years in this time series should be at least one; if so then it is not clear whether in case the historical period with available default data is dominated by downturn years whether certain downturn years should be excluded to avoid introducing upward bias in the average. Moreover, if the minimum length of the historical time series should be at least ten years then several currently approved PD models for retail portfolios might be considered not compliant.

The Committee also proposes to adjust the way in which seasoning is taken into account in the estimation of PDs for retail exposures, introducing seasoning as a risk factor in the models.

The seasoning effect cannot be taken into account within application (origination) rating models while in certain cases their rating outputs do constitute a significant percentage out of the totally rated portfolio within a month. Therefore the seasoning effect may be captured better when allowing for the adjustment of final PD parameter instead and not forcing certain variables within the rating model. If the proposed requirement is enforced it is likely to require a considerable change in methodology.

With regard to the components of LGD, some Members indicate that their retail methodology, for instance, considers more components beside the long-run average LGD and the downturn add-on. It is not clear whether the BCBS intends to put forward a simplification of the LGD estimation methodology or if the proposal is incomplete, missing the specification of other margins, e.g. estimation error margin, margin for PD/LGD correlation, margin for lending practice changes, margin for collateral-currency mismatch and margin for collateral-obligor correlation.

We understand that the Committee is also proposing to limit the extent to which the downturn add-on leads to undue variation in LGD estimates, and it will consider applying a floor to the downturn add-on, in addition to the floor on the overall LGD. Alternatively the Committee is considering whether to use supervisor-specified add-ons for the downturn component. In case of adopting a supervisory specified add-on approach, it must be taken into account the fact that setting an absolute level can lead to uneven effects for different LGD values (less risky portfolios will be affected more in relative terms). Nevertheless, the downturn impact should be assessed considering the banks' own experiences during such periods since this is also highly depending on the effectiveness of its internal collection and workout processes. While from a methodological point of view this is a simplification, from RWA perspective this may cause a significant increase.