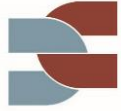




EACB Comments

Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures (EBA/CP/2016/21)

Brussels, 9th February 2017



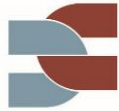
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The **European Association of Co-operative Banks** (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 31 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the co-operative banks' business model. With 4.050 locally operating banks and 68.000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 210 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 79 million members and 860.000 employees and have a total average market share of about 20%.

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Introduction

The members of the EACB welcome the opportunity to comment on the EBA draft Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures.

We support the aim to reduce unjustified variability, and achieve greater comparability, of risk parameters stemming from internal models via a targeted approach that can retain the necessary flexibility and risk sensitivity while restoring trust in the models.

Harmonising and clarifying concepts and methods, rather than prescribing a fixed technique, is an appropriate solution to take into account different portfolios, different risk profiles, institutional experiences, and the economic specificities of the Member States.

General comments

In general, we believe that an overarching clarification should be made indicating that the proposals would only be taken in consideration by competent authorities after the implementation period. In particular, it should be avoided that, in upcoming tests and inspections, conclusions are taken based on the expectations of the draft GL.

All in all we see that the requirements for "segmentation principles", "data requirements" and "human judgment in model development" are appropriately principle-based and generally reflect the industry practice.

On the other hand, the requirements for the inclusion of a Margin of Conservatism (MoC), as defined in section 4.4, point towards a serious need for adjustment in systems, processes and methods. The expectations are very comprehensive, detailed and very concrete and do not seem to follow the overall principle based approach of the draft GL.

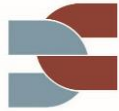
➤ Timeline for implementation

Concerning the proposed deadline for implementation, while 2.5 years seems realistic as a timeframe, we believe that the actual date should be set only at a later stage of the process. In particular, following the feedback to the consultation and taking into account the results of the qualitative survey that was launched to assess the impact of the proposed requirements on the rating systems.

In addition, given the stated close interlinks with the yet to be published draft RTS on the nature, severity and duration of economic downturn to be developed under Art. 181(3)(a) CRR, it would not be appropriate to launch an implementation process that has to be adjusted after a short period.

It is worth underlining that the regulatory changes will have an impact not only on the institutions but also upon competent authorities that will have to review and approve revised models consistently.

Answers to specific questions



Q4.1: Do you agree with the proposed requirement with regard to the application of appropriate adjustments and margin of conservatism? Do you have any operational concern with respect to the proposed categorization?

We appreciate that, as indicated at pag. 42, *"The Guidelines do not prescribe any specific method for the quantification of MoC as the appropriate approach will depend on the character of the deficiency and the available data."* However, the systematic identification and the subsequent assignment to the newly defined categories are associated with considerable procedural efforts. The shift of the conservatism add-on outside of the model into an on-top impact also leads to a systematic structural change of the current model approaches, which while leading to a higher horizontal comparability, does not necessarily improve the model quality.

Q5.1: Do you see any operational limitations with respect to the monitoring requirement proposed in paragraph 53?

A quarterly basis for the calculation of default rates could be sensible. However, the calculation of the default rates is typically carried out in the scope of model validation. A quarterly calculation would generate both procedural and technical expenses. Furthermore, the use of non-overlapping one-year window is allowed for the calculation of the average default rate and quarterly determined default rates would not be directly in line.

Moreover, the GL should at least ensure that the quarterly basis is consistent with the quarterly reporting dates of the institution.

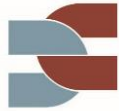
Q5.2: Do you agree with the proposed policy for calculating observed average default rates? How do you treat short term contracts in this regard?

The calculation approaches for determining the average default rate are useful and generally correspond to common practices.

We recommend that an institution should be able to calculate the observed average default rate using both calculations and to set out within its model governance documentation the reason for the choice of one or the other. A change to the approach could be documented and subject to internal independent review.

Regarding short term contracts, some Members report that if customers are not fully observed due to expiring contracts during the observation period, the default rate is corrected accordingly. Different methodological approaches exist, representing a middle way between a full inclusion and a complete exclusion.

Q5.3: Are the requirements on determining the relevant historical observation periods sufficiently clear? Which adjustments (downward or upward), and due to which reasons,



are currently applied to the average of observed default rates in order to estimate the long-run average default rate? If possible, please order those adjustments by materiality in terms of RWA.

Overall, the GL provide a clear framework for the derivation of the relevant observation horizon. At the same time, it should be specified how macroeconomic factors are to be used. It is unclear whether the factors should be considered univariate or interconnected.

Regarding typical adjustments to the long-term average default rate, the following examples are indicative: data scarcity (conservative design of the default rate for low default portfolios); reduced weighting of annual default rates with limited representativeness in the course of portfolio changes (e.g. in the case of portfolio construction).

Q5.4: How do you take economic conditions into account in the design of your rating systems, in particular in terms of:

- d. definition of risk drivers,
- e. definition of the number of grades
- f. definition of the long-run average of default rates?

Some Members indicate that the number of grades taken into account is not influenced by the economic conditions, but it is rather determined by the granularity of the relevant portfolios and by internal procedural configurations.

A full economic cycle is typically used to determine the long-term average default level.

Q5.7: Would you expect that benchmarks for number of pools and grades and maximum PD levels (e.g. for exposures that are not sensitive to the economic cycle) could reduce unjustified variability?

The granularity of the scale and the allocation of default probabilities are strongly driven by the granularity and quality of the portfolio as well as the internal processes. In particular, setting PD caps would not generate additional benefits.

Q6.1: Do you agree with the proposed principles for the assessment of the representativeness of data?

We welcome that the draft GL only require an analysis if there has been more than one change to the definition of default. Moreover, the principles reflect typical implementations currently in practice. This should reduce the burden of model development during the transition phase.