EACB Comments on the EBA DP on the Future of the IRB Approach

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EACB AISBL – Secretariat • Rue de l'Industrie 26-38 • B-1040 Brussels
Tel: (+32 2) 230 11 24 • Fax (+32 2) 230 06 49 • Enterprise 0896.081.149 • lobbying register 4172526951-19
www.eacb.coop • e-mail : secretariat@eacb.coop

Contact:

For further information or questions on this paper, please contact:
- Mr. Volker Heegemann, Head of Department (v.heegemann@eacb.coop)
- Mr. Marco Mancino, Adviser, Banking Regulation (m.mancino@eacb.coop)

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Introduction

The members of the EACB welcome the opportunity to comment on the EBA Discussion Paper (DP) on the future of the IRB approach, and highly appreciate this thorough exercise of transparency of EBA in providing detailed information on the regulatory products already in the pipeline and their scope and possible further actions to come.

We would also like to invite EBA to carefully consider the impacts that the implementation of these changes will produce on the institutions. Numerous areas are likely to be affected, and as an example we can mention at least the work on the definition of default. Once this will be finalised, a retroactive implementation would be almost impossible, and for new exposures the data series could be limited to even less than two years. In this context, possible interactions with the use of data waivers (as per the RTS developed under Art. 180 CRR) should be taken into account to avoid situations leading to withdrawal of authorisation for an existing IRB.

The numerous changes of the models will be significant which will also lead to a wave of re-authorisations from the authorities, and there is no clear indication of how the EBA envisages to deal with this situation. A solution could be to instead treat certain of these aspects under the SREP.

Finally an implementation by 2018 concretely means that institutions shall have to be ready by 2017, limiting further the implementation timeframe.

Answers to selected questions

Q.1 The proposed prioritisation of regulatory products is based on the grouping of such elements that in the EBA's view can be implemented in a sequential manner. Do you agree with the proposed grouping? If not, what alternative grouping would you suggest?

In general we see that the number and scope of regulatory products under way clearly indicate that numerous material changes will be required both for the models and for the institutions' organizational structures. These changes may reveal cross-dependencies, which demand that efforts are taken to avoid conflicting regulations which will raise the burden of implementation. The implementation process should also allow supervisors to adopt sufficient flexibility and appropriate phasing in.

In addition it is not always clear how all the changes demanded by the initiatives envisaged will foster greater convergence of IRB models, and make capital requirements for the same risks comparable. An example is given by the requirements under Art. 4 and 10 of the draft RTS on the Assessment methodology of IRB approach, which touch upon organisational elements of the different institutions, rather than the model itself.

Finally, the priority phases laid out in the consultation paper should be coordinated to a greater extent. Indeed, institutions may be driven to change their models to comply with the RTS on Assessment methodology of the IRB Approach", which is addressed to supervisors, already during phase 1 and further changes may be required when the products under phase 2 and 3 are issued. To allow more effective implementation and reduce costs and difficulties the implementation phases should be more aligned and come at a later stage.

Q.2 What would you consider the areas of priorities?

Due to the costs and resources related to data collection, model redevelopment, calibration, implementation and the related supervisory approval process, we suggest that minimising costs is given sufficient thought when prioritization is set up. In this regard we believe that the 'scope of IRB' should be prioritised together with revision of PPU scope, and especially the inclusion of LDPs. In case a decision is made that PPU scope is potentially applicable for LDPs, or that other boundaries of the current PPU would be removed, all the costs related to IRB changes could be saved for such portfolios that could qualify for PPU. Indeed, it would be very inefficient to carry on the whole exercise of data collection, model redevelopment and a full scale regulatory approval process for portfolios that shortly after would qualify for PPU.

Once IRB scope is prioritized and revised, we believe that the areas which would reveal more critical are the finalisation of the assessment methodology on the IRB approach, the definition of default, the PD estimation and Treatment of defaulted assets.

Q.3 Do you consider the proposed timeframe reasonable? In particular do you consider reasonable the proposed timeline for the implementation of the changes in the area of:

a) definition of default;

b) LGD and conversion factor estimation;

c) PD estimation;

d) treatment of defaulted assets;

e) CRM?

In general it is difficult to assess the timeframes for the implementation of the changes without having a concrete example of what the regulatory products will require. However, where the changes will require vast and deep modifications of processes and procedures, longer implementation periods would be reasonable. This also in light of the challenge that will be posed to supervisory authorities.

In relation to points a) to d) the proposed timeline seems unrealistic. In case backward data collection is made necessary, a 2 year timeline would be unmanageable especially if it includes not only data collection, but also redevelopment, calibration, and change approval by supervisors. Even where data could be collected backwards, the quality of such data is likely to be questioned by the supervisors in a conservative way, which may lead to increased conservativism and reduced risk-sensitivity of models. This we see especially unmanageable for internationally active banks, where historical data is often only available in diverse geographic locations.

We suggest that the time period for implementation is revised in such a way that no backward data collection would be necessary. This would mean 5 years of data collection and another two years for calibration and development before filing an application for material changes.

Definition of default

In this regard the implementation timeframe envisaged seems inappropriate and insufficient. A change in the definition of default would imply significant adjustments for the time series available and consequently to the models. To be implemented, these changes will require longer than 2.5 years, and possibly up to at least five years. In addition it should not be disregarded that such a change would affect also institutions applying the standardised approach.

Moreover also two other elements should be considered. A change in the definition of default is likely to require a great deal of manual adjustments that necessarily demand longer timeframes. Secondly, an implementation period of 2.5 years seems way too short especially for the planned changes to materiality thresholds. If we consider that the standard will be effective since the publication on the Official Journal, and that from that moment national authorities will also require time to calibrate these requirements, the time left to the institution to implement the changes will be minimal.

In any case it should be ensured that changes to the definition of default are made only once, thus coordinating the implementation of the GL on the definition of default and the RTS on the materiality threshold. In this respect, the latter regulatory product is likely to have material impacts on the institutions, which may have to recalibrate data and redevelop estimations for PD, LGD and EAD.

The validation of the models with new PD and materiality threshold will be complex and require careful supervision. In order to have reliable data sets a longer implementation time is needed (e.g. 5/7 years). Moreover, institutions should have the possibility to agree with their supervisor the date of application of the new materiality threshold only after these have been finalised by national authorities.

LGD and conversion factor estimation

We believe that a 2 years implementation timeline is too short for changes in the LGD and conversion factor estimation. In particular, if the LGD is to be calculated with the number-weighted average, a burdensome and longer adaptation time will be needed for institutions currently using a volume weighted calculation method. In general, the soundness of the estimation procedures should be ensured, with no need to impose a prevailing standardised methodology.

Treatment of defaulted assets

It is difficult to assess the appropriateness of the timeline envisaged without details on the concrete proposal.

CRM

A one year implementation timeline seems disproportionately short, unless only marginal modifications will be required.

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

The aspects envisaged for work on the definition of default seem comprehensive. It would be useful if EBA could also provide practical indications helping to achieve a harmonized definition of default. The guidelines, however should not disregard institutions' experience and practices with regard to the definition of default in the IRB approach.

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

When the guidelines are drafted, the supervisory standards for evaluating the historical data collections should also be specified. In this vein, any major deviation in the assessment standards should be avoided, otherwise there is a risk that variability of the IRB models is just reinforced as long time as the backward data is influencing the models. The standards are especially critical for retail and small businesses, where external data collection is extremely difficult.

In addition, it is evident from different experiences, that complete adaptation is not possible and that any approach designed should be sufficiently practical. For instance, when criteria will be determined it should be kept present that the information needed to fulfil them may not be currently collected. In these cases it will be very difficult to fill the gaps ex-post.

The adjustment of historical data will be extremely challenging and time consuming, due for instance to specific data availability. For instance, data warehouses typically store outstanding amounts only at certain reporting dates (e.g. monthly, quarterly), which would make it very difficult to reconstruct exactly historical default dates with a changed materiality threshold. Certain assumptions with regard to the evolution of the outstanding amount between the reporting dates have to be made. We recommend that sufficient time is provided to allow i) adjustments of historical data, and ii) impact studies on credit risk parameters and RWA/capital effects.

The EBA could define minimum standards for the supervisory tolerance of historical data collections and related data quality expectations either in the meaning of defining what could be not acceptable or in the way of defining acceptable methods. For example, whether it would be acceptable to monitor differences between current and proposed definitions for 1 year and adjust the data history backward accordingly. The clarity in the supervisory assessment would reduce the costs that the industry faces in a significant way, especially in relation to the uncertainty in the approval process and would also contribute to the reduction of the variability of models.

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

The answer to this will clearly depend on the option chosen for the RTS under Art. 178(6) CRR on the materiality threshold. The choice may have different impacts in different

Member States, and may require that existing default time series used so far for validation and calibration purposes of all PD, LGD and EAD rating systems would be more or less adapted. This will require extensive credit analysis, that will need not only retrospective enquiry but also concrete experience over new economic cycles (5–10 years). Otherwise, shortened default time series may be considered, although this will affect the accuracy of the models.

In any case, if the effect of a change in the materiality threshold is small, banks should be allowed to apply a simple adjustment factor to central tendencies, especially in case of F-IRB banks.

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

From the discussion paper we have the impression that the new requirements will require vast modifications both in terms of modelling and organisational structure. For this reason, a pragmatic approach that retains sufficient flexibility and an adequate implementation period seem most relevant.

Overall coordination in the introduction of the planned changes should also be ensured. Contrasting inputs should be avoided, and institutions should have the possibility to invest in the modification of their models with sufficient certainty that these investments will not reveal insufficient and/or inadequate. Also, sufficient time for necessary changes in IT architectures should be considered. To be ready by 2018, it would mean that re-authorisation should be provided much earlier to allow appropriate roll out of the new procedures.

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

We share the view that convergence of the approaches and a level playing field should be ensured and we appreciate the aim to increase the stability of IRB and restore confidence in it. However only a case by case evaluation of the measures to be proposed can provide a thorough answer.

In general, it seems that the benefits of the proposed changes may not compensate the current sensitivity of the models due to reduced flexibility for the modelling and the consideration of portfolio characteristics. We believe that the efforts should rather be focused on the transparency of the approaches (e.g. by benchmarking and disclosure) in order to identify and reduce unjustified differences across institutions.

Finally, the choice and calibration of details to be changed in the specified in the RTSs or in the Guidelines must be sensible. A wave of details to be reviewed would mean material changes for most institution. On the other hand, if a description is not specific enough the envisioned convergence of models will not be achieved.

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

Another area that could be addressed regards the margins for conservatism in modelling/calibration, e.g. to overcome representative status issues/data issues etc.

The EBA could also consider providing more specific criteria for the definition of "long run average" or "economic cycle", especially with regard to how many minimum or maximum years are to be taken into account or what criteria could define the beginning and end of a cycle in such a way that it is acceptable to supervisors. In addition, more specific would be needed on such related questions as whether the estimation based on long run averages also requires validation on long run data. And also how supervisors should assess when due to the long run 'average' there could be years when rates/estimates measured on one year data are above the average.

Q.10 Do you have dedicated LGD models for exposures in default that fulfil the requirements specified in section 4.3.4.(ii)?

Some of the requirements outlined may be covered, but this situation may vary for different institutions so that major or small changes could be required.

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

In general, the direction envisaged seem appropriate.

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

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

When specifying conditions for PPU and roll-out, the implementation efforts to be undertaken by the institutions are the key element. These efforts will clearly depend to a considerable extent on data availability, size and age of the portfolio and the strategic importance of certain portfolios. In addition, it should be carefully considered the balance between IRB thresholds and the suitability of certain portfolios for empirical modelling, (e.g. low default portfolios (LDP), Specialized Lending).

In addition, it would be important to define the base measure for PPU and TPU. Especially in case of PPU it is unclear, whether it should be measured only for credit institutions and investment firms (i.e. "institutions") within a consolidated group, or all small legal entities, where naturally/legally (i.e. not covered by CRR on stand-alone basis) only PPU can be used, would count for PPU scope. For instance, application of PPU for small legal entities, performing ancillary activities, could push the ratio of PPU considerably higher on consolidated level than on single institution level. Clarity in such respect would be important for consistent treatment within EU.

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

The restriction from Art. 4(3) of the draft RTS on assessment methodology for IRB approach, preventing cooperation between model developers and model validators under outsourcing arrangements, may create substantial difficulties for pool solutions (e.g. in Germany). For instance, it is not clear how an institution can satisfy the requirement of Art. 190(2)(f) CRR, if it has outsourced the development of the rating system as a key task of the credit risk control unit and Art. 4(3) RTS draft would not allow the outsourcing unit to be involved in the validation unit's activities.

Undergoing pool-rating procedures would entail significant impacts for some institutions: it would require massive adjustments to the IRBA systems and to the organisational structures would be necessary (e.g. installing resources for permanent local model development and validation). It remains unclear whether the validity of an individual institution's models can be shown in the long run without recourse to the shared data pool (as the starting point of shared modelling).

The goal to preserve independence up to the senior management level does not seem to be served concretely. The requirements rather seem to entail vast organisational adjustments but also a duplication of activities, with no apparent benefit. We may also recall that the conflicts of interest in conjunction with model development and its validation are clearly smaller than, for example, for the organisational separation between front and back offices.

In any case, such a rigid organisational separation between validation and model development would clearly delay the model optimisation implementation processes.

Finally, the independence of the validation function, including separate reporting lines, may require considerable re-organisation and imply staffing issues, both in terms of hiring and retaining qualified staff. A completely separate validation function may give rise to difficulties related to high turnover of qualified staff within a seemingly repetitive function. This assumes special importance considering that availability of experienced staff to conduct validation functions is limited and costly, and that is such position it would be hardly appropriate to allocate junior human resources.

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

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

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

In principle we agree that refinements can be made in the area of disclosure. However, before doing so the reason why the current Pillar 3 disclosure channels would not be sufficient would need to be further substantiated. The requirements have already been largely improved and we do not think that there is now a need for publication of additional disclosure.

Throughout its benchmarking analyses, EBA has found certain discrepancies in definitions, methodologies and assumptions for credit risk models. As these elements will be addressed in the future, it seems sensible that until regulatory consistency and alignment is reached, benchmarking analyses and disclosures do not lead to any further generalised conclusion.

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

We do support the EBA guidelines on disclosure requirements. However, the timelines and also the content shall take into account other regulatory initiatives having impacts on data, models and reports, e.g. the BCBS efforts laid out in the Principles for effective risk data aggregation and risk reporting but also IFRS 9.

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

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

Overall, having methodologies for low default portfolios (LDPs) is essential, as these can better reflect the underlying risk in relevant market segments. More generalised approaches such as the permanent and partial use (PPU), are key to grant proportionality and have merit in their simplicity for implementation by less complex institutions, but may also create inappropriate incentives in institutions with solid models, that need to be able to develop their methodologies for LDPs. As an example it can be reminded that collateral is accounted differently under the SA and the IRBA, with clear impacts on capital requirements.

We see merit in moving the definition of LDPs away from the 'exposure segment based' approach to the qualitative and quantitative definition taking into account the number of defaults identified and the availability of external data.

As for the treatment of LDPs, we see that the identified difficulties of internal modelling is a key element. As mentioned under the first question, this could be prioritised as first step in the sequence of regulatory changes in order to save costs in the implementation of the expected regulatory changes. Where necessary the use of the STA approach can be encouraged, as the standards are well known and implemented in all banks. Creating a new regulatory model would further increase the complexity of credit risk approaches, and the definitions of standards, the implementation and a potential approval would be again long lasting and burdensome.

One possibility to overcome the data limitation for instance could be the recourse to pooling models, which grant wider data history and reduce the variability of the estimated risk parameters between the institutions involved. In this case data are pooled from several institutions, and a central outsourced unit (the "pool service provider") develops, maintains, reviews, enhances, and operates collective rating systems. The institutions involved participate in the development and enhancement of the systems. In addition to the pool analyses the central unit provides statistics on each institution's individual portfolio, based on which institutions will perform independent internal validations and examine the representativeness of the pooled data and the validity of the pool results for their own portfolios (Art. 179(2)(b) CRR). Experience shows that there are also advantages for supervisory authorities: they need to audit the models and all changes to them only once and can communicate efficiently with the pool service provider's central points of contact.

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

In general, harmonized solutions could be envisage for certain portfolios like sovereigns or specialized lending portfolios, for which any kind of internal models will be at their statistical borderline. Further limitations of the use of the IRB approach would not be appropriate, while enhanced transparency level (benchmarking and disclosure) could provide as useful tools.

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

The general idea of harmonization might be convincing. However, different institutions may use certain degree of sensibility to adapt their own definitions of portfolios. Thus, the advantages of strictly harmonizing the IRB and the SA definitions are limited, especially when looking at cost benefit considerations.

Based on the provided description it is not clear what such harmonization would mean, which results in would achieve, and ultimately why it should restrict modelling choices under the IRB approach.

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

The TTC approach is certainly a relevant calibration tool for risk management purposes. However, next to institutions using a pure TTC approach it should also be considered that, as noted by EBA, there are other institutions adopting a mix of TTC and PIT. Thus limiting calibration to only one approach does not seem appropriate.

Overall, contingent specificities of portfolios and of the economic framework need to be considered in order not to lose predictive power and to be able to separate trends with accuracy. Indeed, the capital requirements shall always flexibly reflect underlying risk and any procyclical element should be avoided. Moreover it should be considered that ratings are not only used for the purpose of capital requirement but also to steer other elements (e.g. loan pricing. In this respect, and also for provisioning a PIT seems to be more appropriate also considering IFRS 9 and the guidance on accounting for expected credit losses published by the BCBS).

Depending on the portfolios and the risk management practices the use of TTC approach in the rating systems may entail difficulties. For instance consumer lending often requires a horizon of less than one year and a very variable portfolio population.

The current approach allowing the use of the two approaches should be maintained.

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

Removing the possibility for the data waiver would mean that new products, portfolios etc. shall be treated under the standardized approach as long as the depth of data history does not reach the five years threshold. This might harm the utilization of internal models in general or lead to an attitude of overstretching model chance policies respectively tweaking existing models to new products and portfolios.

In addition, the deletion of the "Data Waivers" seems particularly problematic in light of the numerous changes planned in relation to the rating process and the data to be used.

In any case more detailed information would be needed to better assess this possibility.

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

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