![bba - The voice of banking & financial services] ![cml - Council of Mortgage Lenders] ![Building Societies Association]

10 February 2017

A response to the CP on PD estimation, LGD estimation and treatment of Defaulted Assets [1]

February 2017

Introduction

We are pleased to reply to EBA CP 2016/21 on PD estimation, LGD estimation and treatment of Defaulted Assets. This response represents the views of the members of the British Bankers Association (BBA), the Building Societies Association (BSA) and the Council for Mortgage Lenders (CML).

Key message:

We recognise the challenges to *define guidelines that will lead to comparability of the model outcomes.* We agree with the EBA opinion "*differences in risk parameters between institutions should ideally reflect differences in the underlying risk rather than different modelling choices".* A key test of the effectiveness of the EBA's proposals will be '*lowering unjustified variability of risk parameters.* We are pleased to read that the EBA recognises the *operational issues which might arise when following the proposed guidelines'*.

In summary, we support the EBA's objective of greater harmonisation in the approaches to modelling the probability of default (PD), loss given default (LGD), ELBE and LGD in-default. We agree with the EBA that the proposed clarification and harmonisation is necessary to achieve comparability of risk parameters estimated on the basis of internal models. It will also assist in restoring trust in these models by market participants while at the same time preserving risk sensitivity of capital requirements.

We are pleased to read that the EBA views the primary aim of the guidelines is to harmonise the concepts and methods. Also that the EBA is not prescribing any specific estimation methodology where different approaches may be appropriate for different portfolios in order to reflect different risk profiles. In particular we note that the EBA is not mandating the use of Point in Time (PiT) or Through the Cycle (TTC) models or the degree of 'PiT-ness' and that these matters will be left to competent authorities to decide. We agree with this approach. We also agree it is important that institutions and the market has an opportunity to retain some flexibility to take into account institutional experience, as well as the economic and legal specifics of the jurisdictions in which they operate.

We support the EBA's efforts to reduce unjustified variability and the EBA's commitment to retain the IRB approach as the cornerstone of the prudential regulatory credit risk capital framework.

---

[1] http://www.eba.europa.eu/documents/10180/1659311/Consultation+Paper+on+Guidelines+on+PD+LGD+estimation+and+treatment+of+defaulted+assets+%28EBA-CP-2016-21%29.pdf

Overall, we think that the guidelines will be helpful to model developers and reviewers and will provide an extra level of clarification beyond the Regulation and RTS on IRB assessment methodology.[2]

Our main comments relate to concerns on the following:

Low Default Portfolios

We question the extent to which the standards can be applied to exposures to regulated banks and sovereigns.

4.4   Q4.1   Margin of Conservatism

We support the categorisation set out in A), B) and D) and the documentation requirements set out in section 4.4.4. But we do not support the detailed quantification process. We also do not support the inclusion of category C) on the basis that these deficiencies, if they exist, are an integral part of the model development and an adjustment in the calibration if necessary. We think that Margin of Conservatism (MoC) should be seen as a temporary measure and the impact upon RWAs be looked at on an aggregate basis.

Q 5.7   Benchmarking

We are not in favour of establishing benchmark rating grades or pools. We think that the imposition of a standardised Pillar 3 disclosure template is sufficient for comparative purposes.

6.3.3   Q 6.3   Discounting rate

We recognise and support the simplicity of the proposed approach and that it will contribute to reduced variability in the estimation of LGD and thus RWAs.

7.6.2   Q 7.5   Relation of ELBE to specific credit risk adjustments

We urge the EBA to be flexible in its approach to permit those institutions that use SCRAs to continue to do so taking into account materiality and the need for a proportionate approach.

6.3.4   Direct and indirect costs: [3]

We agree with the approach for direct costs. But we think that the approach set out in paragraphs 94 and in section 6.3.4 (paragraphs 123 – 127) for the calculation of indirect costs and allocation to each individual defaulted exposure is burdensome and not cost justified. We think that institutions should be left to determine their own approach to the calculation and application of indirect costs.

---

[2] EBA/RTS/2016/03 Final Draft Regulatory Technical Standards on the specification of the assessment methodology for competent authorities regarding compliance of an institution with the requirements to use the IRB Approach in accordance with Articles 144(2), 173(3) and 180(3)(b) of Regulation (EU) No 575/2013
https://www.eba.europa.eu/documents/10180/1525916/Final+Draft+RTS+on+Assessment+Methodology+for+IRB.pdf/e8373cbc-cc4b-4dd9-83b5-93c9657a39f0

[3] Page 14; Page 59: 6.2 Data requirements for LGD estimation 6.2.1 Reference Data Set Para 94; Page 64 6.3 Calculation of economic loss and realised LGD 6.3.1 Definition of economic loss and realised LGD Para 113, Page 68, 6.3.4 Direct and indirect costs

Timeline for implementation

With regard to the proposed deadline for implementation of end-2020, we think that this date should only be fixed after the EBA has:

1. Had the opportunity to review the comments in response to the CP;

2. Assessed the results of the qualitative survey to assess the impact of the proposed requirements on the rating systems; and

3. Received feedback on the yet to be published draft RTS on the nature, severity and duration of economic downturn to be developed in accordance with Article 181(3)(a) of Regulation (EU) 575/2013. As these RTS will be closely related to the estimation of downturn LGD some additional changes may be introduced in the final guidelines on the basis of the feedback received during these consultations.

We are particularly concerned about the impact of the change on competent authorities' ability to review and approve revised models to enable a consistent implementation date.

We note that the Basel Committee is soon expected to publish its guidance on the use of IRB models. This may also have an impact upon the priority that institutions assign for the redevelopment of IRB models.

Our view is that the concerns expressed by the EBA with regard to the variability and comparability of the risk weights do not apply uniformly across all portfolios across the EU. So competent authorities should be given discretion to determine the priority for the redevelopment of models.

We suggest that a prudent objective may be to prioritise a target of c. 75% of IRB risk weighted assets being compliant by a certain date instead of a full implementation for all IRB model by end-2020.

Taking into account the scope of the changes, we urge the EBA to take a proportionate approach in the implementation of the changes to ease the burden on institutions and competent authorities.

Yours faithfully

John Perry
Senior Consultant,
Prudential Capital and Risk
The British Bankers' Association
T 020 7216 8862
john.perry@bba.org.uk

Jeremy Palmer
Head of Financial Policy

Building Societies Association
0207 520 5912
Jeremy.Palmer@bsa.org.uk

Jon Saunders
Senior policy adviser (funding)

Council for Motgage Lenders
0207 438 8934
Jon.Saunders@cml.org.uk

Response to the Questions posed in EBA CP 2016/21 14 November 2016

4.   General estimation requirements

4.4   Margin of conservatism ('MoC')
4.4.1   Identification of deficiencies
4.4.2   Quantification of estimation errors
4.4.3   Monitoring
4.4.4   Documentation

Key point:

- *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*

Q: 4.1:
- 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?

Q1   Answer:

- We are encouraged to read: "*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, we are concerned that competent authorities may interpret this as a requirement for banks to have a MoC for each category in each model, and that Annex IV becomes more of an example. We welcome the EBA's agreement at the open hearing to consider the need for further clarity.

- We support the establishment of a consistent approach to the categorisation of the MoC, while noting there may be difficulties in separating MoC applied to a model into the various categories.

- We agree with the definitions set out in categories A, B and D, but do not support the inclusion of category C. The two examples given are addressed at the time a model is developed, calibrated, finalised, reviewed and approved for use.

  The proposal requires banks to quantify '*the estimation error that results from the identified deficiency in order to justify the level of MoC at least for every calibration segment for categories A, B and D*'. The proposals state that where '*more than one trigger occurs, a higher aggregate MoC should be applied*'. We understand this will require the calculation of RWA and EL before <u>and</u> after the adjustment of each category of MoC, and in aggregate. This would be operationally too onerous for banks to implement and maintain.

- Furthermore, given the human judgment in model development and application of risk parameters it is our opinion that there may already be MoC within the modelled parameters.

- We think that the EBA may not have considered the complexity of quantifying the offsetting changes to the estimations of PD and LGD.

BBA, BSA and CML response EBA CP 2016/21 PD LGD

- We think that documentation requirements set out in section 4.4.4 is sufficient without the need for detailed quantification of the impact of each MoC.

  The suggestion is that the MoC adjustments will '*result in a more accurate estimate of the risk parameter, where this adjustment can have both positive and negative effect on the risk parameter*'. We believe this is difficult to prove and may result in the introduction of unjustified RWA variance. We think that it is unlikely that the outcome will ever have a positive effect on the risk parameter as suggested in the proposal.

We urge the EBA to bear in mind that a MoC should only be applied until the errors are fixed. The MoC is meant not to be permanent but an interim step. We recommend that the EBA guidelines be clearer on the fundamental reason and purpose of the MoC.

In conclusion we do not support the estimation of the impact on the MoC for each category. We think that an overall estimation is sufficient.

5. PD estimation

5.3 Observed default rates
5.3.1 Calculation of the one-year default rate

Key point:

Para 53. In order to monitor the appropriateness of the PD estimates, institutions should calculate the one-year default rates at least quarterly.

Q: 5.1:

- Do you see any operational limitations with respect to the monitoring requirement proposed in paragraph 53?

Q2 Answer:

We note that the EBA CP does not include any questions about the impact on the implementation of the proposals. We have included comments in our covering letter that are repeated below:

Timeline for implementation

With regard to the proposed deadline for implementation of end-2020, we think that this date should only be fixed after the EBA has:

1. Had opportunity to review the comments sent in response to the CP;
2. Assessed the results of the qualitative survey to understand the impact of the proposed requirements on the rating systems; and
3. Received feedback on the yet to be published draft RTS on the nature, severity and duration of economic downturn to be developed in accordance with Article 181(3)(a) of Regulation (EU) 575/2013. As these RTS will be closely related to the estimation of downturn LGD some additional changes may be introduced in the final guidelines on the basis of the feedback received during these consultations.

We are particularly concerned about the impact of the change on competent authorities' ability to review and approve revised models to enable a consistent implementation date.

We note that the Basel Committee is soon expected to publish its guidance on the use of IRB models. This may also have an impact upon the priority that institutions assign for the redevelopment of IRB models.

Our view is that the concerns expressed by the EBA with regard to the variability and comparability of the risk weights do not apply uniformly across all portfolios across the EU. So competent authorities should be given discretion to determine the priority for the redevelopment of models.

We suggest that a prudent objective may be to prioritise a target of c. 75% of IRB risk weighted assets being compliant by a certain date instead of a full implementation for all IRB model by end-2020.

Taking into account the scope of the changes, we urge the EBA to take a proportionate approach in the implementation of the changes to ease the burden on institutions and competent authorities.

Operational impacts

- We do not foresee any operational limitations.

- In general, one-year default rates are already being calculated at least on a quarterly basis.

- We agree with the requirement to calculate the default rates at least quarterly basis.

- However, it could be an issue for Low Default Portfolios (LDP).

5.3.2   Calculation of the observed average default rate

Observations:

- We note that the EBA proposes to allow two institutions to choose from one of two alternate calculations, non-overlapping windows and overlapping windows.

Q: 5.2:

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

Q3   Answer:

- Yes we agree with the two alternate approaches. We recognise that each could be biased.

- For the purposes of modelling PD our members consider that a default could occur at any time within a year. Some short-term contracts are rolled over and if this is the case then this is also taken into account.

- Our members - where permitted by the regulation - utilise the maturity adjustment - to reduce the Risk Weighted Asset value.

5.4   Long-run average default rate

Key point

Para 62.   In case the historical observation period is not representative of the likely range of variability of one year default rates in order to comply with Article 49(4) of Commission Delegated Regulation xxx/xxxx [RTS on IRB assessment methodology] the average of observed one year default rates should be adjusted in order to estimate a long-run average default rate, in particular where no downturn period is included in the historical observation period.

Q: 5.3:

- 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.

Q4   Answer:

- Yes the requirements are clear. The list set out in Annex III: '*List of economic indicators to be taken into account for determining the historical observation period for PD estimates for particular exposure classes*' is particularly helpful.

- Potential adjustments could be:

    o   If the internal series of one-year default rates (DR) is not large enough to encompass a whole economic cycle, it is generally extended using an external series of default rates which present a high correlation with the internal default rates.

    o   A factor is calculated as the ratio of the average of internal DR and the average of external DR. For periods where the internal series does not exist the internal DR is extended by multiplying internal DR by the factor. If appropriately justified, this adjustment could be below 100%, although this outcome would be rare.

    o   The long-run average default rate is calculated as the average of the extended DR series.

- We do not think that it is possible to rank order adjustments by materiality in terms of the impact upon RWA or EL.

5.5 PD estimation methodologies
5.5.1 Risk drivers and rating criteria
5.5.2 Ratings in PD estimation
5.5.3 Design of grades or pools

Q: 5.4: How do you take economic conditions into account in the design of your Rating systems, in particular in terms of:

      a. Definition of risk drivers,
      b. Definition of the number of grades
      c. Definition of the long-run average of default rates?

Q5 Answer:

- **Introduction:** The IIF RWA Task Force (IRTF) reported that an initial (rating) model may perform as a PiT, TTC or hybrid depending on the factors taken into account or forecasted. It noted that discriminating between systemic and idiosyncratic risk at the obligor level is very difficult.

- The approach to taking into account economic conditions will vary for each portfolio depending on the availability of historical data and the extent to which the portfolio was affected by the downturn. Banks find it a particular challenge to assess the parameters for low default portfolios.

- The number of grades is determined by each bank to take into account its risk management practices. Some banks have grades and descriptions that mirror external ratings in order to assist with rank-ordering and calibration. At the risk-grade level, banks seek to have a grading system in which the TTC PDs exhibit a high degree of stability over the credit cycle and a smoothness of change over time, disturbed only by estimation errors.

- The definition of the long-term average of default rates includes an observed downturn in the economic cycle or if this has not occurred or because the bank is new and the downturn occurred prior to its data series, then as set out in our response to Q5.3. Banks simulate and adjust data to include a downturn. Most banks that use TTC PDs seek to reflect a firm's long-term credit risk trend to filter out cyclical effects.

Q: 5.5:
   • Do you have processes in place to monitor the rating philosophy over time?
   • If yes, please describe them.

Q6   Answer:

   • Banks vary in their rating philosophies, which can be measured by analyzing migration matrices. The higher the "average migration drift", the higher the "PiT-ness" of the rating system

   • However, there is no common way of describing the "PiT-ness" of a rating system

   • We note that the Bank of England has recently proposed an approach to measure the PiT-ness in its Consultation Paper CP29/16[4] *Residential mortgage risk weights*. The EBA may wish to consider the appropriateness of the Bank's proposals.

Q: 5.6:
   • Do you have different rating philosophy approaches to different types of exposures?
   • If yes, please describe them.

Q7   Answer:

We support the comments made by the EBF in its response to this CP as follows:

   • As regards the model philosophy, we support continued flexibility in modelling Point-in-Time (PiT) and Through-the-Cycle (TTC) practices; in fact, the directive and regulations allows different possibilities.

   • Banks that have a structured way of determining the rating philosophy should have the capacity to determine the most appropriate modelling choice. We think that the EBA should strike the right balance between reducing variability and allowing a certain degree of methodological freedom of choice (PiT, TTC) and that it should be the competent authority that should have the ultimate decision as to which approach or degree of PiT-ness is appropriate for the models within its oversight.

   • It is important to distinguish between rating philosophy and calibration philosophy. A bank may have a PiT rating and a TTC calibration in place; the type of approach (customer versus product) also deserves consideration.

   • The frequency of calibration should be set according to the relevance of the model and the changes made.

We note that in the IRTF Final Report there is a wide range of practises: [5]

   • 66.7% for LDPs, 62.5% for other non-retail, and 47.6% for retail reported having PDs that are TTC.

   • However, 79.2% for LDPs, 87.5% for other non-retail, and 81% for retail portfolios reported having either a hybrid or a PIT rating.

---

[4] http://www.bankofengland.co.uk/pra/Documents/publications/cp/2016/cp2916.pdf

[5] https://www.eba.europa.eu/documents/10180/1659346/IIF+on+PD_20170117_final.pdf page 4

Q: 5.7:

- 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?

Q8   Answer:

- No.

- We do not support the mandated use of benchmarks for use in a bank's internal risk management processes.

- As the EBA will be aware, the Basel Committee has mandated a fixed grading structure for the publication of Pillar 3 disclosure. Thus banks are now required to map internal grading systems to a benchmark grading system. We are of the opinion that this does not necessarily improve comparability.

- Our view is that the number of pools and grades should reflect the ability of banks to rank-order risk and should remain so.

6.   LGD estimation

6.2   Data requirements for LGD estimation
6.2.1   Reference Data Set
6.2.2   Representativeness of data

Key point:

- *In the case the definition of default has changed during the historical observation period more than once institutions should perform the analysis of each of the past definitions of default separately.*

Q.   6.1:
- Do you agree with the proposed principles for the assessment of the representativeness of data?

Q 9:   Answer:

We note that the EBA CP does not include any opportunity to comment on the impact on the implementation of the proposals. We draw the EBA attention to our response to question 5.1

Comments on the proposed principles

- We agree with the proposed principles.

- We are pleased that the guidelines have been written to only require an analysis if there have been more than one change to the definition of default. This should reduce the burden of model development during the transition phase.

- However, we are concerned at the proposals set out in paragraphs 93d and 143 which seem burdensome if compulsory, and may not necessarily lead to meaningful outcomes.

- We are also concerned that there may be an inconsistency on the one hand to include all relevant data, but also to exclude some data. We would urge the EBA to provide further clarification on how to eliminate inconsistencies.

- The consequence of a broad historical series can be the impossibility of having complete information for all the recorded defaults and therefore the need to exclude some cases, perhaps because it is not possible to calculate correctly the target variable or they have a different default definition.

- For example the current process of the sample definition in LGD models foresees the exclusions of some defaults for data quality reasons. If all the defaults need to be included in the final sample, for these cases a LGD will be forcedly assigned. The question is therefore which LGD should be assigned? Homogenous guidelines have to be provided in order not to introduce variability. Moreover not only data quality exclusions are performed: for example some defaults are excluded if they are open and their recovery process in progress (they are not considered irrecoverable such as Incomplete Workout cases). For these situations a clear guidance of the recovery rate estimates has to be provided in order not create undue variability among banks.

6.3   Calculation of economic loss and realised LGD
6.3.1   Definition of economic loss and realised LGD
6.3.2   Treatment of unpaid late fees, interest and additional drawings after default

Q: 6.2:
- Do you agree with the proposed treatment of additional drawings after default and interest and fees capitalised after the moment of default in the calculation of realised LGDs?

Q10 Answer:

- The key point is the consistency between EaD and LGD.

- As far as Retail exposures are concerned, we agree with the proposed treatment of additional drawings for both CCF and LGD. Our members' models are aligned with CRR and EBA guidelines.

- The approach concerning fees and interest is very important for an appropriate LGD computation. All the fees are considered in the economic loss as well as all the other direct costs. On the other side the interests can be further divided in two categories:

- **Contractual interest**: These interests have not been considered in the loss rate computation since their inclusion would result in a double counting with respect to the discounting process (whose section is separately treated in the guidelines). In case of perfect alignment between contractual interest rate and discounting rate this treatment would not determine any distortion in the loss rate computation. Nevertheless banks tend to apply a current rates approach for the discounting process as also suggested by the BCBS Working Paper 14: "*their use allows the consideration of all available information and facilitates the comparison between LGD estimates from different portfolios*". This approach can determine negative loss rates for the different consideration of the value of money over time. More specific comments on this topic should be provided in the dedicated section of the guidelines;

- **Unpaid late fees**: These interests are included in the exposure of the denominator of the loss rate. But the guidelines ask banks to consider that, in case of recovery of late interest that have not been previously capitalised, the moment of recovery should be considered a moment of capitalisation. Does this lead to excluding the receipt of unpaid late fees interests and exceeding the amount included in the EAD for the loss rate computation? If the EBA thinks so then we do not agree with the proposal. Our opinion is that a receipt of unpaid late fees should not distort the economic loss estimation. Our opinion is that all the receipts should be considered without any specific treatment for the case of unpaid late fees.

A question for further discussion:

Article 115 states that additional recovery cash flows should be added to the calculation at the date of the return to non-defaulted status in the amount that was outstanding at the date of the return to non-defaulted status and this additional recovery cash should be discounted.

This approach is different from the approach normally used by the banks to discount these recoveries analogously to the other cash flows. Therefore a clarification on this point is requested.

6.3.3   Discounting rate

Key Points as set out by the EBA:

- We are pleased to read *that the discounting factor was recognised as one of the main drivers of non-risk based variability of the LGD estimates. The proposed solution of using interbank funding rates and a 5% add-on has the advantage of being simple and contributing to increased comparability of LGD estimates. It is considered appropriate that the discounting rate should not depend on the credit standing of the institution and hence the discounting rate does not reflect funding costs but is rather focused on the uncertainty inherent in the recovery processes and the time value of money.*

- *Institutions should discount all recoveries and costs, including capitalised late fees and interest and additional drawings after the moment of default using an annual discounting rate composed of a primary interbank offered rate applicable at the moment of default increased by [5%-points] add-on. For this purpose the primary interbank offered rate should be considered the 1-year EURIBOR or a comparable interest rate in a currency of the exposure.*

Q.   6.3:

- Do you agree with the proposed specification of discounting rate?
- Do you agree with the proposed level of the add-on over risk-free rate?
- Do you think that the value of the add-on could be differentiated by predefined categories?
- If so, which categories would you suggest?

Q11   Answer

- We are pleased to see a harmonisation of the approach to the calculation of the discount rate. However, we think that further clarification of the governance process is required to review and revise the discount rate in order to avoid frequent changes to LGD and thus changes to the calculation of risk weighted assets.

- We would like to avoid a direct correlation between interest rates and the capital requirements.

- We are keen to avoid frequent changes to the discount rate.

- A possible approach could be to impose an overall floor of c. 5% for the discount rate (including add-on) and for this only to be changed in the event that the discount rate is on average higher than the floor for at least a continuous period of 12 months.

- We see the principal benefit of the proposal in relation to the discount rate to be the elimination of the variability in the RWAs. However, this benefit needs to be offset by the consequent lack of risk sensitivity.

- We agree with the idea of determining the final rate as the sum of a risk-free component plus a credit spread.

6.4   Long-run average LGD

6.4.1   Historical observation period

Key Points

CRR 181(1)(j)
For exposures to corporates, institutions and central governments and central banks, estimates of LGD shall be based on data over a minimum of five years, increasing by one year each year after implementation until a minimum of seven years is reached, for at least one data source. If the available observation period spans a longer period for any source, and the data is relevant, this longer period shall be used.

CRR 181(2):
For retail exposures, estimates of LGD shall be based on data over a minimum of five years. An institution needs not give equal importance to historic data if more recent data is a better predictor of loss rates. Subject to the permission of the competent authorities, institutions may use, when they implement the IRB Approach, relevant data covering a period of two years. The period to be covered shall increase by one year each year until relevant data cover a period of five years.

Q: 6.4:
- Do you agree with the proposed approach with regard to the specification of historical observation period for LGD estimation?

Q12   Answer:

- Yes we agree with the proposed approach. It is the easiest option and difficult adjustments are avoided.

6.4.3   Treatment of incomplete recovery processes

Key point

- *All exposures that remain in defaulted status for a period of time longer than the maximum period of the recovery process specified for this type of exposures should be treated as closed recovery process for the purpose of calculation of the observed average LGD, considering only the recoveries realised so far.*

Q: 6.5:
- Do you agree with the proposed treatment of incomplete recovery processes in obtaining the long-run average LGD?

Q13   Answer:

- Yes. We agree with the proposals. The EBA proposals are broadly in line with industry practices.

- Relatively long recovery procedures should be allowed when appropriate (i.e. to reflect the legal environment in some countries)

- Also there should be provision for the inclusion of future recoveries linked to collateral for open cases on which collateral has not been used so far.

- A consequence of the proposals is that institutions will need to think carefully about the maximum period of the recovery process. We recommend that the determination of the choice of this maximum period for each portfolio should be clearly documented and subject to periodic review to be determined by the institution.

We have the following additional comments on related topics:

6.4.4   Treatment of cases with no loss or positive outcome

- We agree with the EBA assessment that proposals to establish a floor of zero at an individual level may have a significant impact to models for leasing portfolios.

- However, in situations where the realised recovery is greater than the estimate, the institution will still end up with a lower write-off. Thus the proposals only create a timing difference in the impact upon capital.

6.6   Treatment of collaterals in LGD estimation
6.6.1   Eligibility of collaterals
6.6.2   Inclusion of collaterals in the LGD estimation

Q: 6.6:
- Do you agree with the proposed principles on the treatment of collaterals in the LGD estimation?

Q15   Answer

- Yes we support the EBA approach not to prescribe any specific estimation methodologies.

- However, the proposed guidelines for collateral estimation regularly refer to a single estimation methodology (estimation of recovery rates for collateral). Collateral can be recognised in LGD estimates via other methodologies that produce a single exposure level LGD, based on the level of collateralisation. We request that the EBA clarifies the guidelines so it is clear that other estimation methodologies are appropriate.

- The guidelines are also worded to assume the purpose of collateral is only the repossession and liquidation. It does not recognise that the purpose of obtaining collateral from corporate customers is to improve a banks ranking in the creditor hierarchy that results in lower loss rates during a restructuring process. The objective of this approach is to allow the firm to remain a going concern so it can repay its debts. Liquidation of the collateral (usually company assets) would be counterproductive and possibly increase losses. We also request that the EBA clarifies the guidelines so it is clear that repossession and liquidation is not the only approach to recognising the benefit of collateral within LGD estimates.

6.6.3   Cash flows from collaterals

Q: 6.7:
- Do you agree with the proposed treatment of repossessions of collaterals?
- Do you think that the value of recovery should be updated in the RDS after the final sale of the repossessed collateral?

Q16   Answer

- Yes, we agree with the proposals i.e. that repossession treated as a recovery and it is not necessary to wait until the sale of the asset. In this regard, sales prices could be included to the extent that they help establish adequate haircuts on repossessed valuations.

- In addition to the final sale, the estimated value at the time of the repossession or the estimated value regardless of the repossession should also be stored to enable haircut back-testing.

- Yes, we think the value of the recovery should be updated in the RDS to improve future modelling of the actual recovered value of collateral.

6.7   Downturn adjustment

Q: 6.8:
  • Do you think that additional guidance is necessary with regard to specification of the downturn adjustment?
  • If yes, what would be your proposed approach?

Q17   Answer

  • Whilst it is difficult to comment without seeing the downturn RTS and considering the practicalities of implementation, we are broadly comfortable with the guidance given.

  • The proposals are in-line with methodologies and common practices, however we think that there is a need for additional guidance to clarify the notion of downturn.

  • It would be beneficial if the guidance could include an allowance for banks to
      o Consider approaches based on macroeconomic indicators,
      o Indicate how to relate them to the loss rates (for example through simulative approaches),
      o Consider idiosyncratic factors of the loss rates that do not depend on the economic cycle but strongly influence the loss rates observed (i.e. credit sales).

  • A range of potential approaches should be indicated as well as the proper definition of Downturn conditions. If minimum or maximum impacts of the Downturn factor are expected they should be clearly explained in this Guideline.

7.   Estimation of risk parameters for defaulted exposures

7.1   General requirements specific to EL_{BE} and LGD in-default estimation

Key point

- *LGD in-default – GL 10 seem to allow that downturn adjustment may not be part of LGD estimation for defaulted exposures as it states that downturn conditions should be taken into account in measuring the possibility of additional unexpected losses during the work-out period if they are relevant to a certain type of exposures.*

- *The currently proposed draft GL are clear that LGD in-default should comply with all requirements for LGD estimation and therefore it should also reflect downturn conditions.*

- *As the currently proposed GL provide more prescriptive requirements with regard to estimating LGD for defaulted exposures it may lead to necessity to adjust the calibration of some of the models.*

Q: 7.1:

- Do you agree with the proposed approach to the EL_{BE} and LGD in-default specification?
- Do you have any operational concerns with respect to these requirements?
- Do you think there are any further specificities of EL_{BE} and LGD in-default that are not covered in this chapter?

Q18   Answer

- Although we agree that the revisions to GL10 may require adjustment of the calibration of some models, we agree that the revisions are appropriate and that LGD in-default should reflect downturn conditions.

- However, we think that the transition to a consistent approach will take time. The main topics still to be clarified are:

    o Since the defaulted assets LGD for regulatory capital purposes is strictly related with the Stage 3 LGD on IFRS9, the coherence between the approaches should be considered, for example IFRS9 requires the use of a nominal LGD which is discounted by the effective interest rate directly on the application portfolio. Therefore it is proposed in this case to adopt corrections with respect to the standard approach used for the Performing LGD estimation in order to estimate a nominal LGD which is used for managerial and regulatory purposes and to ex-post discount it for the regulatory purposes as requested by the Regulation (through the discounting rates and an average time of recovery);

    o The treatment of the open facilities has to be clearly documented also in relation to Question 6.5 for Performing LGD. It seems that the requirements in relation to open facilities are different from the section of the open facilities for Performing LGD estimation (refer to question 7.3);

    o The majority of banks currently determine the difference between ELBE and LGD in-default through the Downturn factor.

- o Nevertheless the guidelines require banks to assign all the other MoC to the LGD in-default and not to ELBE. This leads to the question as to which MoC are included in this specification?

- o We would welcome clarification that the assessment of additional UL, in excess of the Downturn factor, for inclusion in the LGDD can conclude that no additional UL is needed and that there is no need for a mandatory add-on.

- o The guidelines could be improved to better define the components differentiating the two LGDs (ELBE and LGD in-default) since their difference determines RWA on defaulted facilities.

- In conclusion the EBA might conclude that it may not be worthwhile imposing full convergence of methodological approaches on LGD for performing exposures to LGDD.

- Convergence could occur for the default series and treatment of the incomplete workouts. The reason being that there is no obvious hierarchy between the values of LGDD and LGD for performing exposures.

7.3   Reference dates

Q19   Answer:

- Yes, we agree with the proposals.

- Our members have confirmed that they do use the reference data approach.

7.4   Calculation of realised LGD and long-run average LGD for defaulted exposures

Key points

- *For the purposes of EL$_{BE}$ and LGD in-default estimation institutions should calculate the realised LGDs for defaulted exposures, in accordance with section 6.3 with the only difference that this should be done with regards to the reference date, specified in accordance with paragraphs 164 to 167, rather than the date of default.*

- Institutions need to carefully determine the methodology to fix the cut-off date.

Q;   7.3:
- Do you agree with the proposed approach with regard to the treatment of incomplete recovery processes for the purpose of estimating LGD in-default and EL$_{BE}$?

Q20   Answer

- Yes, we agree with the proposals. This methodology seems consistent with the treatment of performing exposures, and thus is relevant.

- But in addition we urge the EBA to take into the following responses of the EBF.

  - "We think that the treatment of the open facilities has to be clearly documented also in relation to Question 6.5 for Performing LGD.

  - The inclusion of open defaults can heavily distort the estimates depending on the logic adopted for the modelling technique of defaulted assets.

  - The only exception envisaged in paragraph 169 with respect to the inclusion of incomplete recovery processes in the ELBE and long run average LGD for defaulted exposures is that those can be included only with respect to reference dates beyond which factual recovery and costs have been already observed.

  - We understand that this has been put in place to avoid a circular reference of an estimation within the estimation. We think that the estimation of the future costs and recoveries on incomplete recovery processes should be consistent between defaulted and non-defaulted exposures and should be based, as suggested in paragraph 138(c), on a comparison of the costs and recoveries realised on these exposures until the moment of estimation to the average costs and recoveries realised during similar period of time on similar exposures.

  - For this purpose institutions would analyse the recovery patterns observed on both closed and incomplete recovery processes taking into account only observed costs and recoveries".

- In paragraph 169 we seek clarification of the word '*beyond*'. We think the only exception is that incomplete recovery processes should be used only for those reference dates beyond which factual recovery and costs are observed.

- In summary our opinion is that:

BBA, BSA and CML response EBA CP 2016/21 PD LGD

1. In principle, only closed recovery processes should be considered for the ELBE and LGD in-default estimation for the sake of simplicity.

2. Incomplete recovery process should be considered to the extent reasonable projections can be made (considering at least a 12-month observed period in line with consideration of cures).

3. When collateral is available (and subject to enforceability conditions), LGD should reflect recoveries coming from repossession.

7.6   Specific requirements for ELBE estimation
7.6.1   Current economic circumstances

Observation on text
- *On the other hand taking the example of shipping finance, a default caused by the sinking of a ship is clearly idiosyncratic and **will** generate a lower-than-average recovery, whereas a default caused by a global drop in maritime freight tariffs is influenced by economic conditions. In the latter case, in fact, positive economic conditions during the recovery process may lead to better than average recoveries.*

Comment:
- If the financing is covered by insurance, it may be that an idiosyncratic event results in a better than average recovery!

Key points:
The proposal is that choice of approach is determined by *the sensitivity of LGD to the economic factors relevant to that type of exposure*

- Sensitive: *Adjust the long run average LGD for defaulted exposures such that to reflect current economic circumstances*
- Not sensitive: *The ELBE should be calculated on the basis of the long-run average LGD, as referred to in paragraph 169.*

Q: 7.4:
- Which approach do you use to reflect current economic circumstances for ELBE estimation purposes?

Q21   Answer

- Our opinion is that ELBE should be coherent with the long run average LGD and with the estimates adopted for managerial purposes (analytical-statistical evaluation of NPL, future Stage 3 on IFRS9) since from this comparison the Excess Reserve / Shortfall is computed.

- Based upon the feedback received from our members, the calibration of the ELBE estimates to current economic circumstance is performed using the first of the two approaches set out on page 88; '*considering risk drivers in the model that are sensitive to macro-economic and credit factors relevant for the exposure under consideration. In this way economic conditions will be taken into account in the application of the ELBE by considering the current value of risk drivers for the defaulted file under consideration.*

7.6.2   Relation of EL_{BE} to specific credit risk adjustments

Q: 7.5:
  • Do you currently use specific credit risk adjustments as ELBE estimate or as a possible reason for overriding the ELBE estimates? If so how?

Q22   Answer

  • We agree that that using provisions as ELBE estimates is frequent practice observed within European institutions.

  • It is our understanding that there are banks that use specific credit risk adjustments, but that the proposals would disallow this for the following reasons:

    o   The belief that using impairments is not CRR compliant, citing Art. 181(1)(h) which, indicates that ELBE must be modelled;
    o   Concern the accounting framework allows for too much flexibility in the allocation of impairments which contributes to RWA variance if used for ELBE and
    o   Additional concern that IFRS9 will introduce even more variance if there is no harmonised approach to modelling.

  • Our view is that banks should be able to maintain the use of provisions for ELBE because:

    o   There is little/no material reduction in RWA variance;
    o   Provisioning models are subject to auditor scrutiny and public disclosure;
    o   The proportion of defaulted exposures to overall performing exposures will generally be quite small; and
    o   The change does not meet a cost / benefit test.

  • But if the EBA is still minded to proceed as proposed, then we suggest the introduction of a materiality threshold, or more generally the need for the adoption of a more proportionate approach, to allow the use of impairments for ELBE / BEEL when the proportion of defaulted exposures to overall performing exposures is demonstrated to be immaterial.

  • We encourage the EBA to be flexible in its approach in this regard.

8.   Application of risk parameters

8.1   Conservatism in the application of risk parameters

Q: 8.1:
- Do you see operational issues with respect to the proposed requirements for additional conservatism in the application of risk parameter estimates?

Q23   Answer

- No, we do not foresee operational problems from these requirements.

- However, as there is no guidance on how this additional conservatism should be applied it will lead to inconsistent approaches across the industry. The EBA should consider provision of further guidance.

- It should be acknowledged that as triggers are remediated, the margin of conservatism applied to RWA and/or individual risk parameters should be removed. This should not require a Material Change request and approval.

- We think that the Regulation could be improved to clarify (with some examples) the cases of "*deficiencies related to implementation or application of risk parameters*", focusing only on the most relevant and material.

9.   Re-development, re-estimation and re-calibration of internal models

9.1   Components of regular review of estimates of risk parameters

Q: 9.1:
  • Do you agree with the proposed principles for the annual review of risk parameters?

Q24   Answer:

  • Yes, we agree with the proposals.

  • However, the text suggests that the desired outcome is an optimal model without consideration of cost/benefits to institution.

  • We think that it should be emphasised that Annex IV, if included in the final guidelines, is only an example.

  • The purpose of paragraphs 198 – 205 should be to ensure that RWA is not artificially lowered.

  • We would welcome clarification on
      o   The concepts of re-development, re-estimation and re-calibration, and
      o   What exactly the EBA expects the frequency of the monitoring to be? Quarterly or yearly?

10.   Calculation of IRB shortfall or excess

Key point

- *This has been clarified in the Q&A Question ID 2014_1064. Annex V, Part 2 paragraphs 49 and 50 of Regulation (EU) No 680/2014 (ITS on Supervisory Reporting)* [6] *clarifies that write-offs are the amount of principal and past due interest of any debt instrument that an institution is no longer recognising because they are considered uncollectible, and that they can be caused both by reductions of the carrying amount of financial assets recognised directly in profit or loss as well as by reductions in the amounts of the allowance accounts for credit losses taken against the carrying amount of financial assets.*

- *Such partial write-offs do not constitute impairment, irrespective of the method (specific loan loss provision or direct reduction of the carrying amount) chosen to book impairment in the financial statements of the asset, because any amounts written-back following a de-recognition will not impact the carrying amount of the financial asset (unlike a reversal of impairment losses).*

- *For that reasons a partial write off would not be included in the calculation of general and specifics CRAs.*

Q: 10.1:

- Do you agree with the clarifications proposed in the guidelines with regard to the calculation of IRB shortfall or excess?

Q25   Answer:

- The clarifications are in line with the CRR approach to the calculation of IRB shortfall/surplus.

- However, we note that the CRR deviates from the current Basel 2 framework.

- We suggest that the EBA reconsider their proposals in order to align to the Basel definition.

---

[6] http://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2014_1064

Overall issues

Q   11.1:
- How material would be in your view the impact of the proposed guidelines on your rating systems?
- How many of your models do you expect to require material changes that will have to be approved by the competent authority?

Q26   Answer:

- The number of models requiring redevelopment and competent authority approval cannot be determined on the basis of this guideline alone.

- It is expected that most, if not all, models will require rebuild and approval as a result of the IRB repair programme which will also need to take into account local competent authority changes to methodology for example the UK PRA CP29/16 proposals for residential mortgage risk weights.

- We think that this question should be assessed in the light of the quantitative impact study that the EBA is currently conducting.

- Nevertheless, some indications are that:

    o The LGD in-default guidelines could have a material impact;

    o ELBE could be potentially material in many banks especially if the indirect approach is used; and

    o In terms of PD and LGD, the methodological impact is limited but the operational cost of enhancements to documentation, justifications and changes to processes is significant.

END