
Consultation response

Consultation Paper on draft RTS and ITS on benchmarking portfolios (EBA/CP/2014/07)

18 August 2014

AFME¹ and ISDA² (the Associations) welcome the opportunity to comment on the European Banking Authority's (EBA) consultation paper on the draft RTS and ITS on benchmarking portfolios.

The first section of our response sets out our overarching comments on the consultation paper. This is then followed by a section on practical considerations and our more detailed responses individual to the questions asked.

Overarching Comments

The industry would like to reiterate its strong support for a risk-based capital framework. Whilst the implementation of the risk-based capital framework has been flawed in some cases, we strongly believe that it is a more appropriate approach to capitalise risks in the banking system than to make use of crude alternatives that do not reflect the underlying risk sensitivities.

¹ AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76. For more information please visit the AFME website www.afme.eu.

² Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

Benchmarking is a useful tool in principle but must not lead to standardization

There are a range of tools that are available to regulators to determine the appropriate amount of own funds for a particular firm. These include internal models, stress testing, and the ICAAP/SREP review process. These tools are supported by a control framework which includes internal challenge, model validation, backtesting and the advanced model approval process.

In our view, benchmarking is a useful tool to support supervisory assessments of models and analyse the dispersion of banks' Risk Weighted Assets (RWAs), although it should not be a substitute for competent authorities' expert judgment and common sense, which should be informed by the full range of tools available. We therefore recognise that the EBA's annual benchmarking exercise will be an important supervisory process that will help increase the transparency and consistency of the risk-based capital framework. Nevertheless, we caution against benchmarking leading to a standardization of model outputs.

While we are supportive of the benchmarking exercise, we would like to draw the EBA's attention to the text of Article 78 of the Capital Requirements Directive (referred to hereafter as the "CRD IV" or "the Directive"), and in particular highlight that it is not the objective of the internal models benchmarking exercise to "ensure a common approach" to these models. Article 78 para 5 clearly states that the authorities shall ensure that supervisory actions must maintain the objectives of an internal approach and not "lead to standardization or preferred methods". As set out in the Directive, the exercise should instead highlight approaches that exhibit significant differences in own funds requirements for the same exposures and highlight approaches where there is either high or low diversity as well as systematic under-estimation of own funds requirements.

If the EBA intends to "ensure a common approach" to risk modeling, we believe it would be going beyond the objective stated in Article 78 of the CRD IV. We also think that this would create a systemic model risk. If every institution assesses its clients or operations with exactly the same capital charge, sound risk diversification will be removed and global resilience of the financial sector ultimately reduced. If, on the other hand, the EBA intends to "ensure a common approach" to the review of RWA variability across jurisdictions, then this is something that the industry would support.

Multiple reasons for divergence in RWA outcomes

Many of the differences in RWAs are explained by differences in regulatory approaches, permissible differences in treatment under the Capital Requirements Regulation (CRR), inherent differences in banks' portfolios and differences in supervisory implementation.³ Consistency of risk weights therefore depends to a large extent on

³ See the "Interim results update of the EBA review of the consistency of risk-weighted assets", Executive Summary, page 9, <https://www.eba.europa.eu/documents/10180/15947/EBA+Report+-+Interim+results+update+of+the+EBA+review+of+the+consistency+of+risk+weighted+assets.pdf>

consistent application of internationally agreed regulatory standards by supervisory authorities.

In this respect, we welcome the EBA's efforts to harmonise the application of the regulatory standards by National Competent Authorities (NCAs). In the context of Article 78, we note that the responsibility for detecting outliers and explaining differences in outcomes between banks' models lies with the NCAs. Therefore, in order to ensure comparability of the exercise throughout Europe, we believe that the EBA should be responsible for producing guidelines to determine the points of comparison against which the models are assessed. Moreover, we strongly recommend that the EBA coordinates these efforts with the appropriate international organisations to ensure international comparability of benchmarking exercises.

Standardized Approach metrics are not suitable for benchmarking purposes

In our view, the use of a common, "absolute" benchmark linked to Standardized Approach (SA) metrics is insidious as these metrics are neither risk sensitive nor representative of what an appropriate level of own funds should be. A very likely outcome of a proposal to use SA metrics would be that most, if not all, banks would appear as "outliers". We therefore consider that the sole comparison to SA metrics would fundamentally question the relevance of the EBA's benchmarking exercise.

Industry's recommendations on the composition of test portfolios

With respect to the EBA's test portfolios proposals for **market risk**, given other ongoing workstreams in this area and the tight timeframe for the EBA's exercise, we highly recommend the use of the SIG TB portfolios for 2014. The EBA's proposed portfolios could then be used from 2015 onwards.

For the **credit risk** test portfolios, we support the EBA proposal to alternate annual benchmarking exercises between low and high default portfolios as this will greatly facilitate implementation.

Lastly, while we note that the EBA proposes to align with the Basel SIG TB exercise for the benchmarking of **counterparty credit risk** in 2014 to cover IMM and CVA models, the consultation paper, including the proposed RTS and ITS, contain little information on proposed counterparty risk portfolios, standards of assessment or reporting of the benchmarking for 2014 or from 2015. Given resource constraints at both supervisor and firm level, we recommend that the 2014 exercise cover only the IMM component of counterparty risk and not CVA. Further, we recommend that only one asset class, such as interest rate products, be covered in the first year.

Generally speaking, we would welcome greater industry involvement in those test portfolios that will require further development so that they closely reflect real-life transactions.

The exercise should be targeted to minimize implementation costs whenever possible

In our view, there are certain aspects of the proposals that seem to go beyond what should be required to conduct the benchmarking exercise. For instance, the collection of granular information on individual risk factors is not necessary to monitor or assess the range of RWA or own funds. Particularly given the workload that the provision of such data would create, we are not convinced of its added value in the context of benchmarking.

There are also other requirements listed in the draft RTS that may not be in line with the CRD Article 78 para 7, which only authorises the EBA to develop standards for the supervisory assessment of the benchmarking and related information sharing among NCAs. Our suggestions for amending the RTS text to ensure practicability of implementation are provided in the following section.

Effective communication of benchmarking results will lead to targeted improvements at banks

Effective communication at all levels of the process will be key to its success.

For example, although we fully recognize the constraints of the timetable for NCAs to submit benchmarking results to the EBA (3 months), it will be important to ensure that there is sufficient opportunity for firms to engage with the NCA *prior* to submission to the EBA to ensure factual content or address any outstanding issues.

We would also very much welcome clarification from the EBA on how the results of the benchmarking exercise will be conveyed to banks (i.e. harmonization of the output given by the supervisors to the banks) as well as disseminated into the public domain (i.e. organized around principles of explaining the divergence to meet transparency objectives).

Upon completion of the benchmarking exercises, the industry would welcome detailed bilateral feed-back sessions between supervisors and banks as this will not only allow banks to better understand their own position in the exercise but it is also likely to aid in the analysis and interpretation of the results and understanding the characteristics of positive and negative outliers (without needing to specifically identify the outlier banks). We believe that this would also be beneficial as it would lead to targeted improvement programmes at banks.

Additionally, we see benefits in publicly disseminating the results on a peer group basis so that banks can analyze the results in an attempt to identify the reasons for potential divergence between their firm and their peers.

Practical Considerations

Before answering the individual consultation questions, we wish to point out that the prescriptive nature of the requirements listed in several areas of the draft RTS may not be in line with the CRD Article 78 para 7, which only authorises the EBA to develop standards for the supervisory assessment of the benchmarking and related information sharing among NCAs.

As such, our preference would be to remove Articles 3 para 2 (c) (d), 4, 5 and 7-11 from the RTS completely. In our view, these provisions would be better suited for inclusion in the EBA guidelines referred to in CRD4 Article 78 para 6.

Nevertheless, the text would still require a certain amount of revision in our opinion to ensure practicability of implementation. For instance:

- Art. 5: It is not necessary and indeed not appropriate to require the calculation of benchmark results to be an integral part of a firm's IT solution. In fact, there are significant operational risks involved in having fictitious trades running through live production systems where they could be misconstrued for real transactions. This could lead to cash settlement triggers and real P&L and balance sheet impacts. Instead, banks should be able to demonstrate that the IT solution which calculates the benchmarking results is sufficiently comparable with production results.
- Art. 8 1.i: Parameter calibrations and application are usually not done at the level of supervisory benchmark portfolios (or indeed individual counterparties) and therefore can lead to significantly different results compared to internal performance monitoring outcomes (see the Simpsons paradox well known in the field of statistics)
- Art. 8 1.ii and 10. 1.a These provisions require replication of work done during the approval and review process by competent authorities and should not be repeated in a benchmarking exercise
- Art. 8 2.j: Default and cure rate definitions contain discretionary elements linked to local accounting requirements that establish when a risk provision must be created. Regulatory agreement is therefore a prerequisite to assessing and comparing default and cure rates as part of a benchmarking exercise.
- Art. 10 2: The extensive list of areas for consideration here imposes significant data requirements but does not provide any indication of how the information will be assessed or how conclusions regarding the quality of the underlying models will be derived.

Answers to Consultation Questions

Q1. Do you consider the use of common benchmarks for credit and market portfolios necessary to ensure a common approach?

We acknowledge that defining common benchmarks for credit and market portfolios is useful in increasing market transparency and promoting homogeneity in NCAs' assessments of model outcomes.

However, in spite of the benefits of establishing common benchmarks, we would like to stress that defining inappropriate benchmarks will only make the assessment process burdensome and ineffective and will not be conducive to achieving the objectives of homogeneity and comparability.

In particular, seeking comparability within the risk sensitive context of the regulatory capital framework does not imply risk uniformity. Significant variances can be expected between banks as a natural consequence of having different business models and focus. For instance, as long as the measurement is conservative, it is reasonable that some banks will choose, in cases where their positions are limited in size and/or complexity, to implement simplified internal models whose outcomes may on occasion diverge from other more sophisticated models.

Furthermore, imposing risk uniformity in the financial sector could jeopardize the latter's resilience and increase systemic risk in case (sound) diversity were to be eliminated from market participants' risk assessments. It is therefore important that each institution be evaluated taking into account its own risk appetite and risk profile (for example recovery strategy for loss given default), strategy, internal processes and the appropriateness of benchmark metrics according to its individual market positioning.

Overall, we understand the added value in defining common criteria to identify extreme values but we do not support a universal, common "absolute benchmark" such as the proposal to use the results under the Standardized Approach (SA) as a benchmark.

Indeed, defining a benchmark for the appropriate level of own funds of a single test portfolio is a Sisyphean task. The derivation of an appropriate level can only be the result of a "perfect" model whose "perfection" can only be ensured by means of backtesting and benchmarking with other model outcomes.

Furthermore, the EBA itself acknowledges that the proposed SA metrics is not a perfect benchmarking candidate. Our view is that it is in fact an insidious candidate as it is neither risk sensitive nor representative of what the appropriate level of own funds should be. A very likely outcome of a proposal to use the SA metrics would be that most, if not all, banks would be "outliers". We therefore consider that the SA metrics would fundamentally question the relevance of this test.

We would also like to point out that Article 78 does not require the EBA to define a universal, absolute benchmark but rather to help competent authorities identify those approaches “*where there is a significant and systematic under-estimation of own funds requirements*”. We consider this objective cannot be achieved by comparison to a simplistic indicator but rather must also include an analysis of model assumptions and performance through backtesting and understanding firm specific circumstances and risk appetites.

Consequently, instead of defining single benchmark values, we favour a concept of benchmarking aimed at assessing an acceptable range of variations of risk metrics. The benchmark should also be segmented along peer groups, i.e. using drivers that have proved to be strongly predictive, such as (non limitative list) bank type, asset classes, portfolio balance and size, geographies, etc. We note that data collected in the benchmarking exercises could be used to better refine the above drivers.

Finally, we stress that common standards cannot be a substitute for competent authorities’ expert judgment and common sense but rather a tool to support their assessment of models. In other words, common standards should not lead to automatic investigation by competent authorities but rather serve as a basis for the identification of potential outliers which could require further analysis.

Q2. Do you consider that the benchmarks outlined in the RTS are sufficiently proportionate and flexible? Do you have any alternative benchmark proposals? If yes, please provide details.

Regardless of the appropriateness of the proposed benchmarks (discussed in answer to Q3), the question of proportionality and flexibility is closely related to the obligations imposed on NCAs when a contribution is deemed to be an “outlier” when compared to the defined benchmarks.

To the extent that NCAs are expected to investigate any “outlier” and provide the EBA with feedback, we believe that the proposed benchmarks are overly prescriptive and disproportionate. For the sake of illustration, the “1st and 4th quartile” rule would systematically require competent authorities to investigate half of the contributions. At least a more selective distribution of fractiles (e.g. 5% lowest and 5% highest values), or asymmetric fractiles (e.g. 10% lowest, and 2% highest) could be contemplated as triggers for abnormal calibrations. Similarly, the “80% SA output criteria” is likely to result in most contributions being considered as outliers for market risk test portfolios with diversification/netting features.

Moreover, as the EBA is going to generate the results of the benchmarking based on NCA conclusions (Article 2, RTS), the criteria used by the different NCAs must be comparable. This comparability must be assured by the EBA through a more detailed specification (i.e. more detailed than in the current RTS).

It is also worth mentioning that the benefits of diversification (portfolio and geographical diversification) should be considered within the benchmarking assessment.

Alternative proposals are discussed in answers to questions 3 and 4 below.

Q3. What limitations do you see in relation to the use of the proposed benchmarks, i.e. (i) first and the fourth quartiles; (ii) comparison between own funds under the internal models and the standardized approach; and (iii) comparison between estimates and outturns?

(i) First and fourth quartiles

We recognize the importance of using common and objective benchmarks to identify extreme values. However, we consider the current criterion (1st and 4th quartile irrespective of the dispersion and clustering of the contributions) unsuitable. This is because it can lead to the identification of a contributor being “mechanically” an outlier while, by any reasonable materiality standard, it would not be considered so. For example, in cases of low dispersion where all the contributed results are very close to each other (say, within 1% of each other), 50% of the contributors based on the 1st and 4th quartile rule will still be identified as outliers. Take another example where all contributors have results that are very close together, except for one that is much lower than the others. The 1st and 4th quartile rule would correctly include this latter contributor as an outlier, but it will also include contributors on the high side even though their results might just be marginally higher than most of the firms. To summarise, there is in our view no need to identify outliers when the dispersion is tight and there is no reason why the number of outliers on both side of the distribution should be equal.

Not only would the identification of many these types of false outliers be burdensome for both the regulators and the firms, the 1st and 4th quartile rule can also potentially lead to instability as whoever is identified as a outlier on the downside would want to use a model that generates more conservative results to exit that status. By doing so, next time around, it will not appear as an outlier, while another firm who was previously just within the quartile cutoff might then be pushed out even though it will not have done anything differently.

To overcome these issues, we propose to thin out the percentile range for indentifying potential outliers on top of which we would overlay a materiality rule. Specifically, as a first step, we would identify the top 10% and bottom 10% as potential outliers. Secondly, we would then check if their results are more than x% away (say 20%) from the median. Only those contributors with results more than x% away from the median would ultimately be retained as outliers.

The advantage of this modified rule is that it takes into account both relative ordering and absolute differences. If the dispersion is very tight and no contributor has results more than x% away from the median, then there will be no outlier. However, if there is only one outlier far away from everyone else, it will have been correctly identified without any other contributors inadvertently being called outliers when in fact they are not.

(ii) Comparison between own funds under the internal models and the standardized approach

As explained in our answer to question Q1, our view is that it is not appropriate to define a common reference level of own funds at test portfolio level. Moreover, comparing required own funds calculated under an internal model and the SA could be misleading due to inherent simplifications, omissions and approximations in the parameterization of the SA where sound risk management practices (including business strategies, recovery policies, the presence of collateral, the use of hedging etc.) are not taken into account. By way of example, within the course of the Phase 2 SIG TB market risk benchmarking exercise, CRM floor contributions were even more volatile than CRM contributions themselves.

In addition to being risk insensitive, SA metrics are not universal standards in their implementation across jurisdictions. Not only could the interpretation of the same standards differ across banks, a number of factors under this approach are also open to national supervisory discretion. For instance, the treatment of sovereign risk under the SA is subject to national discretion and a lower risk weight can be applied to banks' exposures to the sovereign of incorporation denominated in domestic currency and funded in that currency.

We therefore believe that the appropriate level of capital for a given portfolio is firm-specific and must be assessed in the light of the firm's ability to risk-manage such a portfolio, the performance of the internal model and the representativeness of the portfolio with respect to the overall internal model. As far as market risk is concerned, should the EBA ultimately choose to maintain SA metrics as a common benchmark, we urge the EBA to consider at a minimum the following:

- The application of SA output as a benchmark should be postponed until the new SA under the Fundamental Review of the Trading Book (FRTB) is implemented for market risk,
- The computation of SA metrics should be performed at EBA level and the methodology used made available to all participating banks. This would be particularly useful for certain specific portfolios where national implementation of SA metrics diverges.

(iii) Comparison between estimates and outturns

Before comparing estimates and outturns, one must assess whether they refer to comparable economic situations. We consider that it is important to compare regulatory parameters (point-in-time, through-the-cycle or downturn) with outturns from the current situation to assess if banks from the same country are equally affected by the business cycle. Such a comparison is a way to assess differences in the dynamics of parameter estimates.

Furthermore, the EBA should give precise technical guidance on the computation of outturns (for instance in the form of a spreadsheet), and these computations should take into account all components of the statistical validity of risk estimates, such as the number of years of available history, default sample size, number of models in use for the respective cluster, etc. This guidance should be developed in consultation with the industry to ensure its suitability and that it can be replicated for institutions across Member States.

Consider for example a portfolio where origination has decreased over past years due to prudent risk management. Perhaps counterintuitively, the cost of risk on the portfolio is likely to have risen over a 5-year history (as the number of contracts in the portfolio will have decreased). However, the relative information within the 5 individual, annual default rates is not identical due to the change in risk profile and risk appetite. We would welcome guidance on how such changes should be reflected in confidence intervals.

Additionally, with respect to credit risk, the use of the 97.5% confidence level is, in our opinion, a new paradigm which may prove inappropriate on some portfolios (for instance owing to various sample sizes or the weight of expert judgment in the rating process). We are not aware of economic or academic studies proving the importance or relevance of such a confidence level.

Finally we believe that competent authorities should not consider the different criteria as single “show-stoppers” but instead they should base their analysis on the combination of their outcome.

Q4. What in your view is the most appropriate benchmark and/or approach for the assessment of the level of potential underestimation of own funds requirements?

Generally, we believe that a comparison between groups of exposures according to certain key drivers is a good idea. In this context, we note that Art 78 imposes the responsibility for detecting outliers and explaining differences on the NCAs. We consider that such drivers have to be established by the EBA and, to the extent possible, need to be the same for all NCAs in order to ensure comparability of the results across different jurisdictions. In our view, the EBA should also assume a more active role in

international benchmarking by coordinating with other international standard-setters and supervisory authorities.

We consider that the only truly robust and valuable approach to identifying the potential under-estimation of own funds requirements is one based on the comparison of model-estimated values and realized values, i.e. backtesting. Nevertheless, NCAs should also use backtesting in conjunction with other sources of investigation like modeling construction and analysis as well as validation history (local supervisory practices and decisions on particular models). Lastly, we wish to stress that benchmarking can never be a substitute for NCAs exercising expert judgment.

Market risk

In order to help identify RWA variance drivers, our proposal is to subject market risk test portfolios to backtesting consistently with the Basel FRTB approach (which introduces backtesting at a much more granular level).

Consistently with its mandate, the EBA's work should be annual and aligned with the timeline of the Basel monitoring exercises.

Credit risk

Lending practices are firm specific and model output and losses will also therefore be firm specific. The application of different accounting frameworks and a firms' accounting policies will also mean that the measurement of losses for the same exposure may be different. It is important that the assessment of firms' responses factors in these differences.

Along the same lines, in some cases NCAs have introduced floors or restrictions on the parameters that firms may use in internal model approaches. Some of these floors may be applied across all firms within a Member State, whilst other floors may be applied on a firm-by-firm basis. We would recommend that the EBA controls for such differences otherwise they may incorrectly be attributed to firms' models and skew the results of the exercise.

Additionally, to avoid creating false outliers, expected losses (%) or RW (%) rather than PDs/LGDs should be the first point of comparison. Otherwise, two banks, one with a very early default definition and the other with a very late one, will tend to have high PD/low LGD and (respectively) low PD/high LGD whereas the results in EL% or RW% could be very similar.

We understand the assessment of internal models is one of the objectives of the "General provisions" laid out in Article 8 of the RTS. Nevertheless we do not fully understand to what extent the NCAs will make use of the information requested in Article 8 paras 1 and 2 of the RTS and would welcome clarification that the EBA will use this information to validate firm specific outcomes.

To conclude this section, we wish to stress that benchmarking exercises of banks' risk assessment must be performed taking model performance into account and by backtesting outputs. It must be well understood that being an outlier in the context of the RWA benchmarking exercises does not necessarily imply that models are not performing appropriately. In fact, a well-performing model means that a bank is doing a good job in predicting its risks and assessing its capital, but it can still produce outlier results in RWA benchmarking exercises.

Q5. Which set of market risk portfolios do you consider more appropriate for the initial exercise conducted under Article 78?

For the initial 2014 initial exercise, we highly recommend the use of the BCBS test portfolios. Indeed, we learnt from previous market risk benchmarking exercises that proper portfolio specification, consistent booking across participants and a pre-validation exercise are key steps to ensure the exercise meets its targets.

Given other ongoing regulatory exercises with overlapping timelines that many market risk experts have been focusing on (e.g. FRTB QIS, BCBS/EBA joint counterparty risk and CVA benchmarking exercise to mention only two such examples) and the very tight timeframe and close kick-off date contemplated by the EBA for the 2014 exercise, we consider that the conditions are not met to ensure the 2014 exercise can be properly performed on the basis of a new set of portfolios

Q6. As explained in the background section, do you consider the approach proposed by the EBA appropriate for future annual exercises?

Market Risk

Given the tight time frame referred to above, we favor the use of HPE portfolios for the first exercise of Q4 2014. Starting from the 2015 exercise, we could then switch to the new portfolios proposed by the EBA.

Moreover, we fully support the EBA's proposition to organize a pre-validation phase to ensure correct booking of instruments. Before the start of any exercise, NCAs should ensure that initial market valuations are within an acceptable range and questions concerning instructions are resolved. Previous exercises such as the FRTB QIS on HPE showed that this pre-validation phase is of key importance to limit the risk of operational errors.

Lastly, we want to draw the EBA's attention on the necessity for banks to receive portfolios specifications well in advance of the exercise. Booking positions in test portfolios, checking them and performing process validation requires time which cannot be reduced. Multiple iterations of instructions should be avoided to the extent possible to limit confusion or late changes to the portfolios.

Credit Risk

We note that previous public RWA benchmarking exercises have in particular highlighted the impact of banks' risk profiles and defaulted assets as being amongst the key drivers behind RWA variability. When benchmarking institutions, the effect of defaulted assets on a bank's global RWA should be controlled or neutralized because, all else being equal, two banks with two different amounts of defaulted assets in their balance sheets will show two diverging RWA.

The benchmarking analysis should also take into account the type of banks being compared: a universal bank and a pure CIB bank may have legitimate divergent assessments of the RWA of the same assets, due to their different specializations.

This being said, we support the approach suggested by the EBA to alternate benchmarking exercises on LDP and HDP. This is because a thorough examination of the results, followed by explanations between supervisors and banks will obviously be a lengthy process, and (at least on the credit risk side) loss trends emerge progressively: macroeconomic changes are the main risk drivers, and will take time to materialize in loss parameters.

The HPE approach for LGD seems to be particularly burdensome to implement, especially as far as secured LGD is concerned, for at least three main reasons:

- This hypothetical exercise would be a true hypothetical exercise (compared to previous HPE exercises that have relied on existing information), since the underlying transactions would not exist. Therefore, the reliability of estimates would be questionable and the workload for banks much higher.
- It is unlikely that banks will be able to provide all the requested information to determine CCF/LGD Secured. LGD Secured is not just a simple function of the collateral only, it also depends on many different factors, including, obviously, the collateral (type, location, condition, etc.) but also the ability to have access to it (seniority of the claim, legal environment, nature of the counterparty etc.), the characteristic of the loan (type, LTV etc.), the usage of the asset, etc.
- The outputs would also depend on the area of expertise of some institutions: for instance, a German bank would be able to give an LGD estimate for a German real estate transaction, whereas it would probably be much more difficult for a retail Spanish bank to give an LGD for a German transaction.

The concept of cluster appears to be a good tool to tackle issues of representativeness and comparability of data collected across banks in the benchmarking process. Nevertheless, clusters should be defined pragmatically along drivers that are applicable to the majority of banks and with appropriate thresholds of materiality. Currently, we are concerned that the level of granularity set out in the EBA's proposals will produce immaterial and unusable clusters.

As for HDP, we consider that the portfolios defined for mortgages are far too granular:

- Until banks set up/adapt an adequate IT solution for reporting for purposes of the benchmarking exercise, all of the requested information may not be directly available from all firms' current IT systems (LTV buckets for instance might be recorded in another business or IT management environment).
- By selecting too many, excessively granular clusters, especially on retail exposures, comparability might be difficult or in vain, all the more so that these portfolios are more sensitive to local specificities.
- Very small clusters would not fit with the range of application of banks' internal models: for instance one cluster could be covered by 2 models which makes backtesting difficult to implement and interpret.

Counterparty Risk

We reiterate that the consultation paper contains little information on the proposed counterparty risk portfolios that would be used for future annual exercises.

Q7. Do you have any alternative proposals? If yes, please provide details.

We take the opportunity here to recall that any alternative benchmarks should always respect the following principles:

- The first step of any benchmarking exercise should be to establish what the key drivers behind RWA divergences are.
- Benchmarks should be expressed in terms of ranges of acceptable divergences rather than single, simplistic values.
- Benchmarking frameworks should be refined by segmentation according to the relevant key drivers of divergences such as, but not limited to, bank type, asset classes, geographical sector, etc.

Q8. Which of the two options for phasing-in do you consider preferable?

We are in favor of option 2, provided that there is no significant evolution on portfolios except what could improve the relevance of these portfolios.

Q9. Do you see any potential ambiguities in the credit risk portfolios defined in Annex I? Please identify the relevant portfolio providing details and any suggestions that would eliminate these ambiguities.

The industry believes that the best way to deal with any ambiguities is through a targeted Q & A process. As an ongoing process for regular benchmarking exercises, it would provide the most flexible and comprehensive platform within which the potential evolution of portfolios and models can be discussed between banks and the EBA.

Nevertheless, we would already like to provide the following comments/questions:

Annex I

- All: Col 060 - We assume that banks would be required to provide the PDs behind the rating scale to support the backtesting.
- All: Col 490 - We consider secured categories to include exposures that are partially secured to align with LGD modeling for single exposures.
- C101 - Portfolio Name & Sector do not seem to be always compatible: e.g. in the "Large Corporate Sample" portfolio, sectors like "Credit institutions" should not be allowed.
- C101: Col 450 - We consider country of residency to be country of operation.
- C102 / C103: Col 130 = Type of collateral is a mixture of collateral and personal guarantees. It is possible to have a personal guarantee or a credit derivative while having physical or financial collateral. Our proposal is to separate collateral and guarantees.
- C102 / C104: Col 270 = facilities like credit lines or credit cards may have both on balance and off balance exposures.
- C103: Col 020 - The templates are incomplete as they do not include Retail Other and Retail QRRE portfolios.
- C103: Col 160 - It is not appropriate to provide maturity for Retail Portfolios as it is not used to calculate capital requirements.
- C103: Col 450: - Annex I considers different countries inside the EU. Annex II mentions only EU/Non-EU options.
- C103: Col 460 - The definition of construction and the rationale for requesting a separate cluster for it and not for other lending types is not clear. For example, it would not capture all forms of lending secured on real estate.
- C104: Col 130 = Seems to be a mixture of real collateral, credit protection and seniority. In our opinion those are different dimensions and should be treated separately. Additionally, In our view negative pledges are not always enforced and / or included in LGD modeling so do not effect recoveries. This should be removed from the benchmarking exercises.
- C104: Col

Annex V

C105: Col 630 - requires firms to provide Long-run PD but this is not used by all institutions - for example Point-in Time PD models

Counterparty credit risk

We note that the EBA proposes to align with the Basel SIG TB exercise for the benchmarking of counterparty credit risk in 2014 to cover IMM and CVA models. We are concerned that the EBA paper contains little information on the proposed counterparty risk portfolios for 2014 or on what portfolios would be used from 2015.

It is also not clear what standards of assessment or reporting will be applied for counterparty risk and CVA as these are not detailed in the consultation paper and more specifically in neither the RTS or ITS. For example, for CVA, it is not clear whether the exercise will be required to capture both advanced and standardized calculations, or whether similar requirements for market risk are relevant, such as initial market valuations.

The EBA paper refers to the 'scarcity of resources and the existing workload both for banks and NCAs. We would agree with EBA's concern about resources and would propose that the 2014 exercise cover only the IMM component of counterparty risk and not CVA. Further, we would recommend that only one asset class be covered in the first year. Benchmarking interest rate products, for example, would cover a significant amount of the exposure and would allow for a meaningful comparison to be made between firms. This would be analogous to the phased approach for credit risk supported by the Associations (i.e. where EBA propose to perform the analysis of High Default Portfolios (HDP) and Low Default Portfolios (LDP) in alternate year).

We note that the counterparty risk sections in Annexes VIII and IX are incomplete. When the EBA is able to publish details on the counterparty risk benchmarking proposals, we would recommend that the EBA considers defining consistent margin terms and collateralisation agreements. Our members would be happy to help define realistic standard terms. This will help ensure that own funds and RWA divergences are correctly attributed to real differences in firms' modeling and risk management practices and not differences that arise from margining assumptions used when the hypothetical portfolios are booked into systems.

Q10. Do you have any suggestions for additional credit risk portfolios? Please provide details.

We support the EBA's proposal to focus on vanilla credit instruments, since comparability is likely to be difficult to achieve on more sophisticated exposures or on exposures held by a limited number of contributing banks.

For a second stage exercise, portfolios could for instance cover liquidity buffer securities held as available for sale in the banking book.

Q11. Do you see any potential ambiguities in the market risk portfolios defined in Annexes VII.a and VII.b? Please identify the relevant portfolio providing details and any suggestions that would eliminate these.

Term Sheets

- In previous hypothetical portfolio exercises there have been differences in the Initial Market Valuation (IMV) used by firms for a number of instruments. This is usually due to the specified instruments/portfolios not having sufficient detail on all elements of the booking. When information is missing, firms must make assumptions to book trades in the systems. We would therefore recommend that Term Sheets be used to specify individual instruments at the start of the exercise as this will reduce the need for firms to make assumptions and reduce the risk of avoidable differences in the IMV.

Booking

- For all instruments, we highly recommend to use settlement dates that fall prior to the IMV reporting date in order to avoid comparison issues with other banks. Positions should be booked at a specific date ahead of the pre-validation exercise and no update should be required on the IMV reporting date in order to minimize the risk of operational errors.

IMV reporting time

- Point 1b mentions timing at 4.30pm London time. However, for most participating banks, the valuation timing in systems depends on the product. We therefore recommend the EBA leaves banks with flexibility in the timing of valuation and instead requires them to report the valuation timing they used for each instrument.

Annex VII.a: EBA market risk benchmark portfolios

- **IR**
 - o IR swaps for GBP, EUR, SEK, DKK and USD are not standard (variable legs indexed on 1 year LIBOR rates). As a result, swaptions written on them are bespoke. We would welcome clarification on the rationale for choosing non-standard swaps.
- **Credit**
 - o Point 1(i) mentions IMM dates should be used. We welcome clarification on whether this refers to IMM relative to the date of the exercise or relative to 21 Feb 2014.
 - o The description of CDS is not always homogeneous, sometimes it includes seniority, sometimes it doesn't (although the RED code is always added, hence seniority is implicit). In order to avoid any doubt, we recommend being systematic by always providing seniority and RED Code.
 - o From September onwards there will be new ISDA definitions for CDSs. This might lead to confusion as to which products to book. If the EBA test portfolios are used for the 2014 exercise, then the EBA would need to give clear guidance.

- Note that for instrument #56 (AXA bond), the correct ISIN code is FR0011322668 and not FR001132266.
- **Commodities**
 - For instrument #32 (crude oil puts), could the EBA give the exact reference of the month on which the put is written (example: WTI Dec-15 future which has a last trading date in Nov-15) and the month used for the strike determination (example: Jun-15 WTI future which has a last trading date in May-15)?
 - For instruments #33 and #34, we seek clarification on the characteristics of the instruments: For instance, are they listed or OTC instruments? Are they ATM? Could the EBA provide specific dates to avoid any confusion?
- **FX**
 - To avoid any differences between banks, we recommend the EBA defines trade details directly rather than by reference:
 - Dates: it would be easier to have the exact maturity, rather than 3M.
 - Strike: Exact strikes could be defined directly rather by reference to “*the rate published by the ECB on 28 February 2014*” or “*the price corresponding to the three-month forward exchange rate as of end of day 21 February 2014*”
 - Additionally, we note some wording mistakes for instruments #30 and #31:

#30. 3-month short forward DKK/USD currency, (*short long DKK, long short USD EUR*) with 1 USD Million purchased at the DKK/USD reference rate published by the ECB on 28 February 2014

#31. 3-month short forward SEK/USD currency, (long USD, short *EUR SEK*) with 1 USD Million purchased at the SEK/USD reference rate published by the ECB on 28 February 2014

Q12. Do you have any suggestions for additional market risk portfolios? Please provide details.

For FX test portfolios, we propose to introduce a FX vanilla option out of the money with a strike far from the FX forward by 2.33 standard-deviations. The goal is to check if the VaR captures the convexity between the current FX Spot and the 99% FX Spot bump: does the methodology use a Taylor approach or a full Revaluation? For the sake of illustration, the related strategy could be:

Sell call eur put usd with strike = Current FX Fwd x (1 + 1%) and sell put eur call usd with strike = Current FX Fwd x (1 - 1%)

Q13 Do you agree with the possibility of allowing firms to refrain from reporting portfolios if one of the conditions stated in Article 3 is met?

We indeed think some exemptions should be granted, especially when they contribute to a better understanding of the results overall (in practice, adding minor portfolios at the expense of the overall precision of the results would be undesirable).

We suggest the following process: banks select the portfolios which they think would be legitimate to exclude, based on a series of objective factors. These would be defined by the NCA and include quantitative factors (see below) as well as qualitative factors (e.g. portfolios in run-off). A discussion would then take place between the supervisor and the bank to reach a conclusion on whether it is appropriate to exclude such portfolios, or maintain them in the analysis.

Nevertheless, we do recognize that exemptions could lead to comparability issues for all-in portfolios.

Q14 Do you have any suggestion about additional exemptions from reporting? If yes, please provide details.

We would also welcome similar exemptions market and credit risk:

Exemptions should include situations where the firm is under a model validation process for portfolios included in the samples and immaterial portfolios. A materiality threshold could be defined as:

- An absolute portfolio size and/or
- A relative portfolio size, in comparison to the total consolidated balance-sheet or to the balance-sheet size of the subsidiary.

We would happily help EBA in defining such materiality thresholds but we also believe that materiality could alternatively be defined in relative terms as per RTS on Model Change policy.

Portfolios with partial roll-out should also be exempted. Alternatively, the share of the portfolio under the SA should be highlighted and the bias resulting from different capital treatments eliminated. Moreover, as mentioned previously, any bias created from differing levels of defaulted assets should also be removed.

Exemptions should also include exceptional and temporary situations that are fully documented by the bank asking for the exemption, such as M&A situations impacting existing or new assets of the bank.

Lastly, local entities supervised by a host supervisor should also be exempted from solo reporting as long as their portfolios are included in the consolidated vision submitted to the home supervisor.