AFME Consultation response to:

EBA Consultation on RTS on the identification of an economic downturn and Guidelines on the estimation of the LGD in a situation of economic downturn.

[28] June 2018

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to contribute to Consultation on **EBA RTS on the identification of an economic downturn** and **Guidelines on the estimation of the LGD in a situation of economic downturn.**

General comments:

The final Basel III agreement will influence the scope of these consultations and the Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures. Therefore, we consider that it is paramount to align the timeline for implementation of these consultations with the implementation deadline of the Basel III final agreement (i.e. 2022) given that different implementation timelines and overlapping requirements would prove counterproductive for the implementation of changes in internal models and would entail significant operational burden for banks.

However, if the EBA decides to not align the implementation deadline of these two consultations with the Basel III final agreement implementation deadline, it should at least be aligned with the implementation deadline of the guidelines on the PD estimation, LGD estimation and treatment of defaulted assets consultation paper (i.e. end of 2021). Indeed, these three consultations are complementary and should not be disentangled, as they act as a package aiming at reducing the unjustified variability of the LGD estimated.

Overall, we welcome the new approach of the EBA, which splits out the estimation of downturn LGDs into Guidelines, as well as the additional impact analysis undertaken since the last consultation. Indeed, we fully support the separation of the specifications of the characteristics of the economic downturn from the methods to be used when estimating the LGD. In its current format, we believe that the implementation costs are substantially reduced with respect to the initial consultation paper and the new proposal is more easily understandable, although for some banks it will still generate a lot of complex work for a limited increase in the final downturn LGDs, particularly once mortgage LGD floors have been applied. Regarding the RTS to identify an economic downturn we appreciate the proposal not to restrict to one year the duration of the severity under determined circumstances. Regarding the nature of the economic downturn, we also appreciate the EBA list of economic factors which are relevant for the purpose of specifying the nature of an economic downturn for a considered type of exposure. This would enhance consistency and convergence in the modelling practices across the banking industry.

It should be noted that as well as greater flexibility we would like to see introduced, we would also welcome a more simplified approach in some instances. The comments we have prepared are based on qualitative assessment and do not reflect more quantitative analysis which would be a much more extensive undertaking. These comments and concerns regarding the workability of the RTS and the maintenance of some aspects of the original RTS, as well as the new proposals for Guidelines are set out in further detail below.

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Consultation response on the EBA RTS on the identification of an economic downturn

Overview:

The implementation of this RTS (along with the GL) could be unduly burdensome and complex to maintain in the model lifecycle process, as the analysis of period downturn must be done for each economic factor, each downturn period, each type of exposure / asset class etc. We would therefore welcome greater flexibility in order to accommodate the granularity and diversity that banks may have in their classification processes.

In addition, we are concerned these RTS would mean institutions are faced with duplicative regulatory requirements and would welcome clear incentives to maintain a risk-sensitive framework which avoids unnecessary regulatory burden. In particular, we note the establishment of a more harmonized "downturn estimation" (which will be complex to implement) is closely interrelated with:

- Determination of ECL using IFRS 9 models and its possible review with a new "downturn" approach
- The consistent implementation of IRB Repair program within an ambitious timeline and the related supervisory process (2-step approach when applicable, application for model changes…)
- The challenge to keep a consistent framework with the use of internal models, in the context of the finalization of Basel III agreements and especially its European transposition
- The possible application of prudential backstop for NPLs and its indirect impact on ELBE / LGD-in-default

We think that flexibility and efficiency are therefore essential in such context, to maintain institutions' existing methodologies where these have been proven to work and do not lead to arbitrage or understate the final level of LGDs.

Q1: Do you have any concerns around the workability of the new approach (e.g. data availability issues, burden on the analysis, split between the definition of the economic downturn and its impact on the internal loss data)?

Duration of an economic downturn - 20-year look-back horizon and data challenges

AFME members consider there is no legal mandate or clear rationale to justify a look back over 20 years of economic data and it is unclear why the RTS/GLs contain examples which refer to periods earlier than this - 1990/1991 are 27-28 years ago. This idealised approach in our view does not reflect the reality of reduced data availability from looking back to a period pre-dating Basel II modelling, structural changes (technology, product evolution), and changes in government macroeconomic policy (interest rate targeting).

Furthermore, introducing a 20 year look back period will not be possible for all types of data. Indeed, in terms of LGD estimation a lack of data is addressed with an increasingly conservative approach and the 20-year horizon means is likely to lead to a position whereby this increasingly conservative approach is locked in for a significant period of time.

However, if the EBA chooses to retain it, we believe the 20-year economic horizon should be cumulative as valuable information would be lost if a rolling approach is used. For example, the Global Financial Crisis would drop out of the assessment after 2028/29. This could result in a sudden reduction in downturn LGD estimates. It is important that this should be clarified otherwise competent authorities may have different interpretations which will lead to divergent in practices.

We are also concerned by how to correlate the economic factor series with the internal loss data as the link between LGDs and economic factors may not always be evidenced using statistical models.

Finally, we support the proposal of not restricting to one year the duration of the severity since it may not reflect the typical duration of a downturn. In this regard, we support the provisions included in the RTS to adapt the duration of the downturn to the specific economic circumstances experienced in each jurisdiction.

Economic indicators (for specifying the nature of a downturn)

We appreciate the EBA's list of economic factors which are relevant for specifying the nature of an economic downturn for a considered type of exposure. This will enhance consistency and convergence in the modelling practices across the banking industry. However, we would like to point out on potential issues derived from the use of external default rates or aggregate credit losses series. These are usually provided as the ratio of the exposure of defaulted loans and total exposure, thus having a cumulative nature. Even if differences are taken, the series might provide a distorted view of the economic downturn as they may be conditioned by the non-performing loans disposal strategy. Thus, we suggest considering these series only as a reference to underpin the conclusions coming from the use of the rest economic factors and only to the extent that they provide meaningful information.

Moreover, while we support the proposed separation between the economic downturn identification and the incorporation of the downturn effect in the LGD estimation, it should be noted they are closely connected. The identification of a downturn period in step 1 should be based on economic considerations as well as analysed *in light* of its impact on expected recovery. For example, the selection of an economic indicator which is not strongly correlated with internal loss experience may lead to an underestimation of LGDs. Although these factors are generally economically significant, for most credit portfolios there could be some instances where the significance of one or more factors would be minimal such that taking these factors into account would be unnecessary.

Therefore, we recommend that there is some flexibility over the use of the four economic factors set out in Article 2, or that institutions be given the ability to "switch off" these factors in cases where their irrelevance can be justified. All four indicators should be tested for inclusion, but justified exclusions should be allowed on the following basis:

- Where the LGD model covers multiple geographies, it may be impractical to use both GDP and unemployment rate for each of the jurisdictions in scope. A possible alternative could be to examine GDP and unemployment rate for the most material countries or countries that represent more than a certain percentage of the portfolio. But even with this approach the number of downturn periods could be unmanageable. External data for aggregated default rates and credit losses may not be available in all jurisdictions. Instead, we recommend use of internal data, where available and sufficient, as internal data is more relevant and more representative of internal experience. In addition, it will be particularly challenging to obtain the information in the index to be considered for the economic indicators under Article 2. Thus, it would be useful if EBA provides clarity on the types of sources from where banks can collect this information both for geographies inside and outside EU as well as for the different industries (since customization and analysis of co-movement are required in par. 3).
- Mandatory use of multiple economic indicators can lead to unnecessary complexity (see feedback on CP Downturn LGD estimation) and can discourage use of alternative, potentially more relevant, indicators, for example composite credit-cycle indices that are a function of relevant economic indicators.

Severity of a downturn

While judging the severity of the impact may be subjective, the proposed solution to look beyond the 20-year time horizon (Article 3, para1(c)) may not be very effective as the relevance of older data to the expected internal loss experience may be hard to demonstrate. We recommend a more flexible approach on the selection of the indicators, as per comments related to Article 2, and the exclusion of those indicators where the peak/troughs in the relevant data period is not particularly severe (for example the Unemployment rate

change in Figure 6 shows moderate peaks and troughs compared to the other two indicators and may lead to spurious inference). In the RTS mandate under Article 181(3) of CRR the requirement to assess the severity of a downturn does not necessarily require the worst scenario but could potentially be an average of the different scenarios observed in the past. We consider Credit Factors and LGD should be representative (conditioned to the analysis of their significance with the dynamics of the loss rates as correctly stated also in Section 5 of the EBA GL) of a downturn period if characterized by higher values compared to the long run, and not necessarily of the "worst downturn period" ever registered. We deem more appropriate that the severity is representative of the "empirically observed" severity and of the empirical impact on loss rates.

It would also be beneficial to have clarity under para 2 on whether banks are expected to rely on quarterly data to establish the annual data for the economic factors or if banks should use another reference date. This is relevant for the analysis of adjacent peaks/trough and the possibility to have longer than 12-month period of downturn.

Regularity of institutional review of the RTS after initial adoption:

The EBA does not specify how often institutions are meant to reapply the RTS after the initial adoption. We believe annual updates to identify whether new economic downturn periods have occurred in the last year is sensible. Publishers of economic factors can restate historic metrics and we believe the annual update would be sufficient to capture this.

The annual update would apply to the RTS requirement only and only if a new downturn period is identified should the institution then undertake activity to analyse the impact on its LGD estimates.

Q2: Do you see any issues of applicability of this RTS for estimating conversion factors appropriate for an economic downturn identified in accordance with this RTS?

AFME consider that the GL should mention explicitly that they do not apply to conversion factors (CFs) in order to ensure Supervisors apply the rules in a harmonised way.

As we understand it, however, the applicability of this RTS is the same for estimating CFs as for LGD, to the extent that the RTS only identifies downturn periods and that there are not specific guidelines to estimate downturn CFs. We are concerned about applying similar guidelines to the estimation of CFs as those proposed for LGDs, which may lead to an undue burden on institutions and could result in inadequate estimates.

In particular, we consider the adoption of the proposed approach for estimation of conversion factors CFs suffers the same potential drawbacks as those identified for LGD. For example, global wholesale portfolios are not likely (or expected) to be segmented by geography for EAD estimation purposes, if the bank has consistent exposure management practices across the portfolio. Hence, mandatory use of GDP and unemployment rates as downturn indicators could lead to unnecessary complexity (if both indicators are included for each of the jurisdictions) or excessive simplification (if the GDP and unemployment rate of one country is used as a downturn indicator across the portfolio).

Furthermore, if several downturn periods are identified and for some of them it is not possible to observe realized CFs, it may be extremely difficult to extrapolate the behaviour of CFs in such periods.

We consider that credit risk policies are the driving influence behind the behaviour of conversion factors - much more so than macroeconomic factors, so that in some cases CFs may even decrease during economic downturns due to the tightening of credit limits. Hence, it is expected that statistical relationships with economic factors will vary over time according to the specific credit policies applied thus making difficult proposing, for CFs, the kind of adjustments required in the LGD estimation consultation paper. Indeed, estimates are generally based on long-run values. Where a downturn period has been identified according to macroeconomic variables, the long-run CFs are typically compared to those obtained from realized defaults in that period. If the latter values are greater, then those are chosen as regulatory CFs.

Following this line of reasoning, even if realized CFs can be observed in more than one period, the behaviour of CFs may be fundamentally different according to the credit policies applied at each point in time. Thus, it would not be appropriate to apply downturn CFs resulting from *old* credit policies if the Entity can demonstrate that these credit policies are no longer in place.

Therefore, in order to avoid an excessive complexity without benefit to the estimates and to preserve the risk sensitivity of capital requirements, we suggest at the very least (if it is to be applied to CFs) to base CF estimates on long-run values unless, from the observed internal experience, a downturn CF can unequivocally be proposed. This hypothetical downturn CF should be consistent with the latest downturn experienced and the credit policies in place at the time of application.

Finally, we would note the CRR does not permit institutions to model LGD or CF for Equities and so the identification of economic downturn periods is not required (RTS Article 2(1)(b)(vii).

Consultation response on the EBA Guidelines on the estimation of the LGD in a situation of economic downturn

General comment: AFME considers the current structure of the Guidelines is overly mechanistic and too focused on how to calculate the downturn estimate. This risks the EBA not meeting their objective to reduce variability in banks given the complexity and granularity of introducing such a highly theorised approach to the modelling. To address this, we believe it would be useful and help reduce LGD variance if the EBA were to focus on explaining what a downturn LGD should represent before going into the detail of the estimation approaches available to achieve it. In this respect a more simplified approach based on the materiality of these RTS and GLs could be introduced. One way to do this may be to adopt an approach based more on guided examples or principles for the guidelines, within which their methods for estimating the downturn LGD can sit. The principles and examples, for instance could include among others what the downturn LGD estimate looks like (i.e. the EBA seem to prefer a worst-case downturn in the last 20 years); the level at which the downturn is estimated (model or exposure class); the maximum period after the downturn in which the lag in increased losses could occur.

We draw the EBA's attention to our response to question 2 for the RTS and request the final GLs explicitly state they do not apply to the estimation of Downturn CFs, in order to avoid future misinterpretation of the requirements. We do not support the development of GLs for the estimation of downturn CFs.

Application of the Economic Downturn period to Downturn LGD estimates:

Regarding the level at which the downturn is estimated, we recommend the EBA allows flexibility in this space, rather than mandating a calibration level only, so that banks are able to respond to inconsistencies expected to be encountered at the calibration level and exposure type level.

Applying the downturn at calibration segment means models within the same exposure class (or even across exposure classes) may estimate downturn LGDs based on variables which do not/cannot occur at the same time. We consider that ignoring any offsetting trends will lead to a situation where we create a synthetic downturn period – or downturn period effect – that is not supported by the data. Portfolio and diversification effects, as a result of good risk management, are not accounted for and banks could be required to hold capital for unexpected losses that are higher than losses observed in any single previous economic downturn period.

For example, in the GLs (para 16) the EBA uses the retail exposure class to illustrate how different economic downturn periods may impact different retail LGD models to a different extent (mortgages, consumer credits and overdrafts) and in this situation the models should use different economic downturn periods to estimate Downturn LGD (1990-1991 and 2008-2010 in the example). However, these periods may be characterised by conflicting macroeconomic conditions, such as high/low interest rates, meaning the LGD impacts couldn't occur at the same time. In practice it would therefore mean banks would have separate models for mortgages and other retail lending.

Conversely, applying the downturn at exposure type may result in increased complexity for banks when more than one exposure type is in scope of the model. Our members observe situations where a group of customers rated on a model can be categorised into different exposure types by the CRR rules. For example, banks are classified as institutions except when they are incorporated/regulated outside the EEA, when they are classified as corporates.

Q1 **Do you think that additional guidance around the estimation of LGD in-default, which reflect downturn conditions, is needed? If yes, could you provide examples of sound methodologies for transposing downturn LGD estimates from performing to non-performing exposures?**

Members agreed additional guidance would be helpful provided it strikes and appropriate balance between suggested methodologies and limiting the operational burden to implement. For example, the approach proposed for the estimation of LGD in-default would create an undue burden for banks. It would imply not

just the identification of the downturn period for each calibration segment considering the time in-default as an additional risk driver, but also the estimation of the downturn LGD in-default for each segment and downturn period. Taking into account that multiple downturn periods may be identified and that the application of the different approaches (section 5, 6 or 7) is required, we consider that this the methodology proposed would therefore increase the number of calculations needed.

With this in mind complexity should be limited. We list below some suggestions from our Members on potential approaches the EBA might wish to consider:

- One methodology could be a simplified approach for the estimation of LGD in-default. To avoid an excessive complexity, this proposal would be to estimate the downturn LGD in-default based on the downturn period selected for the LGD estimates of non-defaulted exposures which is applicable to the LGD in-default. Therefore, once the downturn LGD for non-defaulted exposures has been obtained (by applying the approaches proposed in the Guidelines), the downturn LGD in-default should be the LGD corresponding to the same downturn period. Thus, each calibration segment would have a unique downturn period, avoiding inconsistencies related to the downturn period identified for the performing and non-performing exposures;
- Another view was that LGD in-default that appropriately reflect an economic downturn could be estimated based on the downturn estimation methodology performed for the LGD estimates of non-defaulted exposures;

Q2 Do you share the concern that the proposed policy in paragraph 15 could create an undue burden if applied to every downturn period identified? If yes, in order to better balance the accuracy of the estimations and its operational complexity what evidence should be provided by institutions in order to justify the exemption of identified downturn periods from the proposed policy in paragraph 15?

We consider that proposed policy in paragraph 15 could create an undue burden if applied to every downturn period identified. This would result in a disproportionate amount of additional workload with little added-value.

The EBA should simplify the proposed policy, with the aim of striking an appropriate balance between the solutions proposed and their complexity and operationalization.

One approach could be to apply an exemption of identification of downturn periods in the following additional cases (to be documented and approved by the supervisor):

- When a major macroeconomic crisis is taken into account in the observed or estimated impact (and the level of final LGDs is not understated)
- When the link between LGDs and economic factors may not be evidenced using statistical models, especially where these links are not justified on an economic reasoning or where data is heterogeneous (e.g. the definition of default may not be homogenous during the historical period). Banks won't necessarily have 20 years of historic data on LGDs – the minimum requirement under CRR is 7 years.

Alternatively, where multiple downturn periods are identified and the downturn LGD estimates for each period can be provided in accordance with the methodology set out in Section 5, it may not be necessary to calculate the downturn LGD according to the methodology set out in Section 6.

Some exemptions for instance that could be considered to the methodology in section 6:

- In the case of mortgages (or where collateral plays an essential role in estimation), if the period for which the loss data is not available is not related to a specific factor for this type of exposures (house

prices or house price indices), then the downturn LGD should be assessed taking into account just the period for which the loss data is available (and apply the methodology set out in Section 5). On the other hand, if the period for which the loss data is not available is related to the specific factor, then this period should be also considered and the downturn LGD should be assessed in accordance to the methodology set out in Section 6.

- Similarly, for other portfolios, where there are sufficient grounds for not considering the downturn period for which the loss data is not available or relevant (for example, for old cases of downturn potentially not representative anymore), the downturn LGD could be assessed just for the periods for which the methodology set out in Section 5 can be applied.

Indeed, for wholesale portfolios, excessive segmentation and multiple downturn periods could result in low number of observations in each segment. Limiting the number of mandatory economic indicators should reduce that risk. Increased complexity could lead to unintended consequences (e.g. ranking of obligors/facilities is inconsistent between LRA and DT estimates) and further complications (e.g. difficult interpretation of stress test impacts). Another alternative to reduce operational complexity could be to examine GDP and unemployment rate for the three most material countries or countries that represent more than a certain percentage of the portfolio. As there is no current requirement to segment EAD by geography, the suggested approach creates difficulties for global portfolios.

Q3 Do you agree with the proposed level of downturn LGD estimation set out in paragraph 14? In particular, do you support the concept that the downturn LGD estimates of different calibration segments could be based on different downturn periods? Is the policy on the level of downturn LGD estimation as well as the relation between the level of downturn LGD estimation and the relevant downturn periods sufficiently clear?

In general terms, we consider that the estimation of LGD downturn of different calibration segments should be based on the same downturn period. Therefore, the definition of a 'calibration segment' needs to be clarified. We wouldn't expect to use different downturn periods within a portfolio (e.g. UK mortgages). While we can envisage scenarios where different segments of a book are more heavily influenced by different economic factors (e.g. unemployment versus house price trends) this would not result in using a different downturn period. Consequently, this would add an unnecessary complexity and it would be difficult to understand how a portfolio (if having multiple calibration segments) would behave under a stress scenario.

In addition, we agree with paragraph 14 in the sense that the estimate of the downturn LGD should be made at least at the same level as the long run LGD, that is, using the same calibration segments that have been used to calibrate the LGD to the average long run values, since otherwise the downturn values and the long run values cannot be compared.

Notwithstanding this, we consider that a clarification in the calibration segment concept is essential as this concept is not sufficiently clear in the Guidelines of PD estimation, LGD estimation and the treatment of defaulted exposures.

Finally, in order to be aligned with the RTS on the nature, severity and duration of an economic downturn, the identification of different downturn periods should be done at the level of type of exposures. That is, when different downturn periods are identified for different types of exposures, the impact of the downturn period should be done at the level of exposure type. The example on pages 12 and 26 does not adequately clarify this issue (it is unclear why the impact of the Downturn period 1 should be estimated for calibration segment B, as the economic factors that identify this downturn period are not specific for this type of exposures).

Question 4: Do you consider the description of the approaches to be sufficiently clear?

While the description of the approaches is relatively clear, it is not always clear when each of the approaches should be adopted. For example:

- Further guidance should be provided on what sufficient loss data looks like as, without this, two separate banks may draw different conclusions and apply different methods, driving variances in banks risk weights.
- In certain model constructs, the haircut approach may be appropriate even if sufficient downturn data has been observed; such data can be used to validate the estimated impact of a downturn. We would ask for a clarification that these approaches can still fall under the requirements of Chapter 5, rather than 6. for segments where insufficient data is available, it is unclear how the requirements of Chapter 7 relate to existing regulatory frameworks such as use of FIRB values/floors.

We would also question the proposal under para 33 in section 5 to adopt the maximum average LGD in case of more than one downturn period. As per our comments on the severity of a downturn in the RTS, we consider that the average value on downturn periods would represent in a better way the level of loss rates in negative phases of the cycle.

Furthermore, we deem it should be clarified in both section 5 and 6 the interaction between downturn, model components and the attribution of the downturn effect at overall LGD level (i.e. with the inclusion of all model components).

Disentangling the effect at model component level is relevant in order to concentrate the attention on more significant effects in assessing the cure rate, and time in default, while for realized LGD and annual recoveries only the closed not cured cases should be consider, since these ones are flattened by the artificial cash flows.

In addition, also under the extrapolation approach, the realized LGDs at overall level (i.e. both cured and not cured cases) are characterized by strong bi/multimodality, that cannot be significantly estimated through a linear regression model. Thus, also in this case, it would be methodologically more grounded to concentrate the analysis on cases not cured for realized LGD, and to operate only on cure rate for the downturn effect.

In order to ensure the proper downturn effect at overall LGD level (i.e. in a comparable basis with the long run average overall LGD) for the aggregation of model components the downturn effects on the single intermediated model components should be aggregated, taking into account that the downturn period identified by RTS criteria might affect positions in different stages of the NPL life cycle. Therefore, a credit file in a phase of "soft collection", can be affected by a period of downturn in terms of reduced possibility to cure. However, once migrated on liquidation, the downturn might be finished, and the liquidation phase might be run in a more positive way, and vice versa. Thus the risk of doubling the downturn effect estimated at model components level in the phase of their aggregation should be avoided (see what reported in par. 29).The estimation of downturn effect at model components level should be rather used as an instruments for the calculation of the downturn effect at overall level, e.g. by worsening only those model components of the overall estimation affected by downturn in a certain period of the NPL cycle and then looking at the different level of increase of the estimates compared to the long run ones.

As an illustrative example, let us assume a long run average overall LGD risk quantification sample where for each defaulted facility "i" within the time series covering from the "Oldest default date" available and the "sample cut-off date" at the moment of Downturn LGD estimation, the overall long run LGD estimates is represented by the combination of the following two model components:

- cure ratio;
- LGD for Liquidation and Cure Scenarios

$$LGD_{i,overall} = \left(P_{i,cure} * LGD_{i,cure}\right) + \left(P_{i,Liq} * LGD_{i,Liq}\right)$$

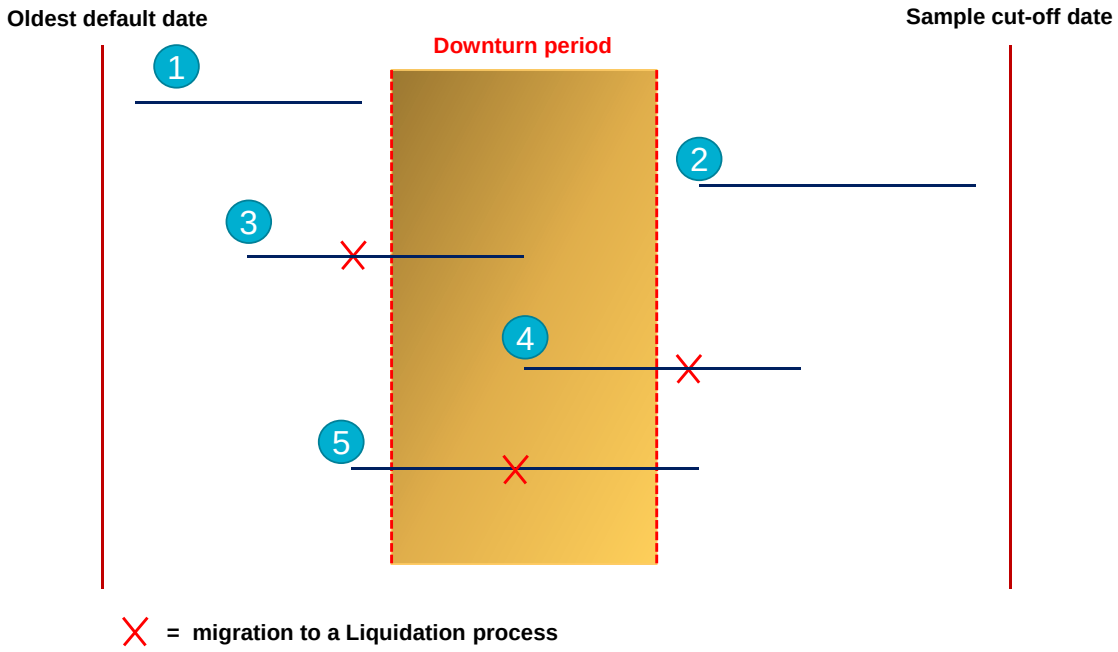
where

- $P_{i,cure}$ is the cure ratio estimate resulting from the LGD model given the risk factors of i-th defaulted facilities;

- $LGD_{i,cure}$ is the LGD estimate for cure scenario resulting from the LGD model given the risk factors of i-th defaulted facilities;
- $LGD_{i,Liq}$ is the LGD estimate for liquidation scenario resulting from the LGD model given the risk factors of i-th defaulted facilities;
- $P_{i,Liq} = 1 - P_{i,cure}$

Following Section 5 or Section 6 a downturn impact is estimated both for cure ratio and LGD for Liquidation scenario, thus a downturn estimate for both model components is applied ($P_{i,cure\_Dwt}$ and LGD_{i,Liq_Dwt} respectively). For the the long run average overall LGD quantification sample the situations reported in the chart below can occur.

Long Run average overall LGD risk quantification sample



We can have observed defaulted facilities whose default windows (i.e. time interval between starting and end date of default, including also probation period and independence period treatment as for par. 101 of EBA/GL/2017/16) fall completely outside the downturn period (Cases 1 and 2). On the contrary we can have cases crossing the downturn period (Cases 3, 4 and 5):

- in case 3 the defaulted facilities are affected by the downturn period exclusively in the Liquidation phase (i.e. after the red cross);
- in case 4 the defaulted facilities are affected by the downturn period exclusively in the pre-Liquidation phase;
- in case 5 both phases are impacted.

In this context the Downturn LGD of case 5 should be equal to:

$$LGD_{i,overall\_Dwt} = \left(P_{i,cure\_Dwt} * LGD_{i,cure}\right) + \left(P_{i,Liq\_Dwt} * LGD_{i,Liq\_Dwt}\right)$$

whereas in case 3 and 4 the downturn period should not affect the model components because in the former (the latter) the $P_{i,cure\_Dwt}$ (LGD_{i,Liq_Dwt}) should not impacted thus:

$$LGD_{i,overall\_Dwt} = \left(P_{i,cure} * LGD_{i,cure}\right) + \left(P_{i,Liq} * LGD_{i,Liq\_Dwt}\right) \text{ for case 3}$$

$$LGD_{i,overall\_Dwt} = \left(P_{i,cure\_Dwt} * LGD_{i,cure}\right) + \left(P_{i,Liq\_Dwt} * LGD_{i,Liq}\right) \text{ for case 4}$$

In a context of representative overall LGD quantification sample, as required by Regulation, the overall Downturn LGD estimates can be defined by getting a downturn adjustment based on the ratio between:

$$Dwt\_adjustment = \frac{\frac{1}{N}\sum_{i=1}^{N} LGD_{i,overall\_Dwt}}{\frac{1}{N}\sum_{i=1}^{N} LGD_{i,overall}}$$

considering all the defaulted facilities crossing the downturn period (i.e. all the cases 3, 4 and 5).

This approach would take into account the NPL-cycle phase as well as the multiyear nature of the LGD parameter since cases that are already in a Liquidation phase will be affected only in the realization of its workout process whereas cases in a pre-Liquidation phase might risk, more likely, to migrate to a Liquidation scenario. Given the composition of cases 3, 4 and 5 in a representative overall LGD quantification sample the downturn effect of the single model components (based either on observed or estimated impact) are reverted at overall level, avoiding biased effects. Furthermore, this will be a relevant element to consider in the inclusion of the downturn effect on LGD in-default estimation since in this case the different stage of the NPL-life cycle is a relevant information of the estimation.

We deem that the analysis at both section 5 and 6 should be done considering only the closed cases since the inclusion of open cases with inference would determine an estimation based on another estimation.

AFME also considers the specific approaches could also benefit from the below clarifications:

Downturn LGD based on observed impact (section 5):

- We would welcome further clarity and guidance on how the relation with observed loss rate data and economic factor – this is central the recognition or not of a downturn effect and it will be relevant for discussions with national competent authorities once the GL enters into force;
- Analysis of the impact of the economic downturn period on loss data: Clearer guidance is required on how to reach a conclusion on the effect the economic downturn on realised LGD where one (or more) of the components assessed have positive outcomes during the downturn period and they offset any negative outcomes from one (or more) other components – the net effect being no impact is observed.
- The guidelines could provide greater detail on how to recognize the observed impact of downturn taking into account the interaction with other regulatory estimations (e.g. ELBE, IFRS9, Stress Testing) where a range of future economic conditions, which although different from historical downturn ones, should be recognized. to reconcile between. The proposed framework should consistently support the different usages of the risk estimates.
- The CP recognises that a lag can occur, but no further guidance is given. Our concern here is that having invested considerable time to identify and analyse the downturn periods for each model, we effectively then look for periods where loses are high within the vicinity of the downturn which to all

intents and purposes makes the work to identify the downturn period redundant. Guidance on a time period for the lag would be useful (i.e. is the EBA fine with a 9-month lag but not 3 years?).

Downturn LGD based on estimated impact (section 6):

Where data does exist to model long run average estimates, but there is insufficient data to model the downturn, further guidance is needed over how to apply method 2 (haircut / extrapolate) so institutions do not need to apply the 20% add-on under method 3. The concern here is erroneously high losses or spread of losses during the downturn could unjustly influence a downturn calibration.

We would also welcome clarity of our understanding in relation to the examples given in the GL for the extrapolation / haircut approaches, that institutions should apply the most relevant and appropriate methodologies in accordance with their modeling assumptions (the examples provided in the GLs are examples which can be adapted).

Haircut Methodology:

Chapter 6, art 25: The haircut methodology involves expressing LGD as a function of some economic indicators rather than setting them to their downturn period values. It is not clear if this economic indicator needs to be drawn from the mandatory list of indicators used to identify downturn. If it is not, and the downturn period can be identified using a different set of macroeconomic indicators to those that drive internal loss experience, there is no guarantee that the values of the economic indicators used to model loss will be conservative during the previously identified downturn period. As the methodology is quite prescriptive, there is not much room for the application of judgment. On the other hand, if the economic indicators that drive LGD need to be taken from the mandatory list used for downturn identification, then there is no guarantee that these will prove valid drivers to explain loss risk.

This issue leads directly from similar comments in response to the specific question (choice of economic indicators for downturn identification, disconnect between downturn identification and LGD estimation, limited flexibility of the framework to account for methodologies that incorporate relevant risk drivers via a regression approach).

Extrapolation Methodology: The extrapolation approach suggests that the macroeconomic indicators should be identified according to the RTS approach, using the mandatory list of drivers at a minimum. The mandatory list of drivers may not have a strong correlation with loss experience, so the inclusion of such indicators as macroeconomic drivers in a statistical LGD model may prove impossible. We do not consider it appropriate to quantify the MoC based on the residual of the regression since the extrapolation is performed by means of the estimated coefficient. It would make more sense to consider the standard error of the beta.

In addition, regarding the interaction with Low Default Portfolios approaches for LGD estimation we recommend the EBA explicitly state that an additional downturn adjustment is not required where FIRB LGDs are used due to the paucity of data to model LGD. For example, where the PRA SS11/13 requirements apply to floor LGDs for LDP portfolios where <20 observations are available. The extrapolation approach (para 39) already recognises this could be a challenge.

Question 5: Do you agree to the limitation of approaches for quantification of downturn LGD estimates? If not, which other approaches should be considered? Would you prefer the alternative policy considered – if yes how should a minimum MoC be established in this case?

Although we acknowledge the benefits of limiting the number of approaches for quantification the downturn LGD in terms of harmonization, we are concerned about the applicability of those approaches for rating systems with scarcity of defaults, but for which external or pooled data exists to model LGD. For these portfolios, we consider that the use of the minimum MoC set in Section 7 is extremely conservative. We think that is more appropriate to include the alternative of using external data for quantification of the downturn LGD, including a MoC related to the representativeness of the external data.

Regarding the alternative policy considered, we consider that it is operationally more complex, and it is unclear how the suggested analyses could be incorporated into the modelling process. In addition, we consider that the disaggregation of the impact in four components could lead to confusion when providing economic interpretation to the results. We think it should be focused on the points (1) estimated realised LGDs and (2) estimated recoveries, taking as secondary or additional analysis the points (3) estimated number of creditors that default and returned to the non-defaulted status and (4) estimated time in-default, since, these latter components are already directly engaged in the estimation of the realised LGD. That is, they would already be taken into account when calculating the realised LGD, since points (3) and (4) can not necessarily be affected by the economic cycle but also could be affected by the internal policies of the entity.

Question 6: Do you expect that the total exposure amount or share which is treated with the policy proposed in Section 7 is material?

The total exposure amount or share which is treated under section 7 should be non-material in order to avoid potential misinterpretation by competent authorities which may consider it as a "case-by-default" and apply Section 7 systematically. Indeed, we do not expect that the total exposure amount treated with the approach proposed in Section 7 would be material, as for most of the exposures the historical information available covers a significant period of time that allows the use of more accurate approaches as the ones described in Section 5 or 6. If the portion treated under section 7 is material the incentive to remain on AIRB may be limited, as section 7 may return higher LGD estimates than FIRB and be more burdensome to maintain.

We'd also note the explanatory text seems to clearly state that this would only be applicable in rare circumstances – we request the EBA provide further guidance on whether this should be interpreted to include newly established portfolios having not yet experienced a downturn. The EBA should also clarify that section 7 does not apply portfolios with a longer history which includes a 'downturn' period but the downturn has limited impact on this portfolio.

More generally, we view the 20% add-on as too conservative and could result in an unjustified risk of over-estimating LGDs. Although we understand the intention is to provide a strong incentive for an internal estimation of the downturn adjustment, we think that in cases such as LDPs the lack of data availability is a crucial issue. It would be useful for the EBA to provide further rationale on the choice of the add-on level (20%).

The EBA could also consider introducing a multiplicative add-on rather than a fixed 20% add on, in order to set the add-on proportional to the long run average LGD level. Alternatively, the EBA could give banks the flexibility to replace the 20% add-on with the reference value approach, calculated consistently with Sections 5 and 6. As the reference value relies on internal loss data, some members considered it more adequate than an arbitrary forfeit value. The reference value approach would consequently be disregarded as a benchmark option.

Question 7: Do you have specific examples of types of exposures which will fall under the policy proposed in Section 7?

For some banks they a have material portion of the portfolio for which some data is available for the identified downturn period, but the data is of limited representativeness for the internal portfolio (and insufficient for robust estimation purposes).

Without the sufficient flexibility in the Guidelines or Supervisory approach, this section would most impact low default portfolios as since these are exposures that inherit the same internal information problems to estimate the long run LGD.

Question 8: Do you agree to require a minimum MoC quantified via a fixed add-on to the long run average LGD? If not, which of the alternatives should be considered? Do you see reasons for differentiating the fixed add-on according to exposure classes?

- In addition to the weaknesses of the backstop solution proposed in Section 7 an additive add-on would not be risk sensitive and would result in a disproportionate increase in capital requirements. We would therefore recommend a multiplicative add-on, which would be commensurate with the idiosyncrasies of the portfolio which recognises the specificities of the portfolio (e.g. size, the specific features, nature, LGD level...). Or alternatively as proposed in Q6, the EBA could give the option for banks to drop add-on approach in favour of using the reference value approach. More consideration and analysis should be given to whether the MoC should be applied to the LRA LGD rather than the downturn LGD.
- If introduced, the scope of the add-on could benefit from greater granularity (rather than differentiating according to exposure class) in order to take account of the portfolio's specific features.
- Finally, it could be useful for the EBA to make explicit whether the MoC should be part of the LRA LGD or DWN LGD. As we understand it the MoC set out in para 21 are specific to the LGD estimation and wouldn't be part of the LRA LGD.

Question 9: Do you agree to the minimum MoC as the max(0,min(20%, 105% - LRAVLGD)?

We consider that the proposal to set an additive add-on of 20 pts is overly conservative and not appropriate for some portfolios, resulting in an excessive increase of capital requirements. Lower risk does not necessarily mean there is greater proportional impact on losses as a result of an economic downturn. Moreover, we do not see the rationale to set the threshold for the LGD of 105%, as this threshold will discourage entities to invest in the recovery process of the loan. We consider that the LGD threshold should be set at 100%. See answer to Q6.

Question 10: Is the policy regarding the reference value sufficiently clear? Alongside with the potentially limited applicability of the reference value to the downturn LGD estimation according to paragraphs 18-19, for what reasons could the reference value feasibly be omitted? Do you agree to the proposed clarification of the role of the reference value?

We recommend the following clarifications to the reference value approach:

- The policy (not only this chapter) seems to assume a certain methodological framework, whereby Downturn LGD are estimated as a single value in each of the calibration segments. However, regression-type models will produce a range of Downturn LGD estimates in each segment, as a function of selected risk drivers. In this scenario, the nature of the comparison may be complex and the conclusions subjective. Aligning a range of values with a single benchmark will negate the risk discriminatory value that the inclusion of the risk drivers aims to achieve. The policy could usefully clarify that, in these circumstances, the comparison should be made in reference to the *minimum*, *maximum* and *average* downturn LGD estimates in each calibration segment.
- It would be beneficial to specify that, even if the reference years are identified according to total losses, the reference values should be calculated as default-weighted averages of realised LGDs at facility level. Only, it must be noted that identifying the years according to total losses may be unduly influenced by the presence of individually significant exposures entering in default (for example, in low default portfolios).
- We agree with the clarifications suggested in the explanatory box on this section, however, it must be noted that, according to the RTS, it may be the case that the duration of the downturn period is longer than two years (for instance, in the case of a prolonged recession). In such cases, we suggest adapting the length of the reference period to the duration of the downturn or, alternatively, considering this as a case where the reference value could be, albeit not substantially, above LGD estimates.
- We acknowledge the reasons behind setting the reference values. However, they may end up setting, de facto, floors to the estimates, thus reducing the incentives for entities to improve their recovery processes. For example, a situation where two exact downturns are experienced and where, in the

second one, the entity is applying more intense recovery policies, how could this be reflected in the estimates if they are tied to reference values? We understand that LGD estimates should be periodically back tested considering representativeness aspects (as described in 32 (a)) and from these conclude on whether LGD estimates remain valid, without the necessity of explicitly considering reference values.

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