

Consultation response

EBA Consultation on Draft Implementing Technical Standards amending Commission Regulation (EU) 2016/2070 with regard to benchmarking of internal models

31 January 2018

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the European Banking Authority's (EBA's) consultation on Draft Implementing Technical Standards amending Commission Regulation (EU) 2016/2070 with regard to the benchmarking of internal models. 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.

We set-out below our comments on the proposals in the consultation, and include as separate sections wider and more general observations and a summary of more technical points on which industry would appreciate clarification.

In terms of the proposed changes in relation to credit risk, we consider that in general these should allow for increased clarity and improved analysis. There are, however, several areas in which potential issues could arise. For instance, it would be helpful to have clarity on the rationale for the portfolio constructions, especially where new portfolios are introduced or existing ones amended. This would help firms to be consistent in their interpretations. It would be helpful also if the structure of the exercise is kept stable as far as possible and that portfolios IDs are not fully renumbered. In any case, duplicates in portfolio IDs within and across the templates should not form part of the definitions.

For market risk, we consider that the shortened timeframes will impact on resources and could compromise quality and the overall validity of the benchmark. There is concern also that the reporting templates are too detailed in places and that as such there is an increased scope for increased operational risk and interpretation errors, which in turn reduce the quality and comparability of the output. In order to allow sufficient time for institutions to perform the necessary quality checks, we propose moving the risk calculation period to the period from 21st January to 4th February 2019 and moving the risk remittance date to 1st March 2019. The proposed reshuffling of portfolios will also increase the technical effort needed and it would be welcomed if these could now remain stable and not be subject to substantial changes each year. In addition, we have noted that there is no reference to the format in which data should be submitted and that we expect it therefore to remain unchanged as XBRL.

Credit risk

Changes proposed in the consultation

Separate on and off-balance sheet exposures.

- *The ITS proposes to explicitly separate on and off-balance sheet exposures so that they can be analysed separately (see new column 180 “Balance sheet recognition” created for this purpose in C.102 and C.103, Annex I and Annex II). For off-balance exposures, a weighted CCF should be reported, and these values can be benchmarked since they reflect the outcomes of internal models (in AIRB).*

Splitting the exposures into on and off-balance sheet exposures provides meaningful weighted Credit Conversion Factors (CCFs). Additional clarity is needed on how to report the exposures from derivatives, Securities Financing Transactions (SFTs) and contractual cross product netting (for instance, the product classes as used for Common Reporting - COREP reporting), as currently it is unclear under which category they should be reported. It would be helpful if it were explicitly stated that on-balance sheet exposures also cover derivatives SFTs, and cross product netting.

We would suggest reviewing also the breakdowns based on Type of Facility in C 102.00 and C 103.00. They are currently based on different and excessive granularity. A more simplified approach might be suggested based on the opening of type of facility breakdowns based on the same approach as for Regulation 575/2013 (e.g. Full/Medium/Low-Medium/Low risk) and to set “not applicable” the Type of Facility for On-Balance and for CRR exposures.

Replace RWA* and RWA by confidence intervals (C 103.00).**

- *The ITS proposes to replace RWA* by two quantities forming a confidence interval: [RWA-, RWA+]. In this proposal, RWA- is defined in analogy with RWA* with two differences: (i) The PD floor is removed, so that PD* is truly determined by the observed default rate; (ii) The confidence $q = 97.5\%$ is lowered to $q = 90\%$. RWA- will then form the lower bound of the confidence interval, since RWA- describes the portfolio RWAs with a PD that is very aggressive w.r.t. the default rate. Analogously, a quantity RWA+ should be defined, the upper bound of the confidence interval, describing RWAs based on a PD that is very conservative w.r.t. the default rate. The formula for RWA+ would be essentially the same as the one for RWA- (RWA*), where, however, p^* is the largest value such that the inequality with the inequality sign changed from \geq to \leq is satisfied.*

AFME and its members are supportive of this change, with the following observation.

In assessing the position of actual RWA within the interval [RWA-, RWA+] the rating philosophy of the underlying rating models should be considered.

Indeed, in case of low sensitive rating philosophy models (hence characterized by low sensitivity to the economic cycle) and high DR latest year, the regulatory RWA could be below the relevant RWA- because the PD model is not designed to catch the yearly DR fluctuations due to macro-economic changes. Hence, the apparent under-estimation would be perfectly justifiable. The same situation could occur in case of high sensitive PD models when the five years default rate is particularly high in comparison to the last year default rate. In this case the model is designed to follow economic fluctuations and hence regulatory RWA could consistently be below the relevant RWA-.

We would note separately that the definition of RWA* and RWA** has been changed several times in recent years and there has been difficulty in interpreting the definition correctly and in understanding the aim of the calculation and how they have been used as benchmark values.

Specialised Lending

- *Specialized Lending (C 101.00). The ITS proposes to clarify that specialised lending exposures are excluded from the scope of C 101. Add a general instruction in Annex IV and remove “Specialised Lending Slotting Criteria” as an option for the Regulatory Approach (column 140 of Annex I C 101).*

Specialised Lending (C 102.00). The ITS proposes that specialised lending exposures shall no longer be mixed with other credit risk exposures – portfolios will be defined with a new dimension ‘Type of exposure’ which defines whether or not specialised lending exposures are to be included. Specific portfolios covering all specialised lending exposures will be defined in table 102 of Annex 1. No other portfolios will include specialised lending exposures.

This guidance is helpful. Specialised lending exposures are now clearly separated on C 102.00 for the Large Corporate portfolio and are excluded from the template C 101.00. However, for the Large corporate sample on C 102.00 the type of exposure is ‘not applicable’, suggesting that specialised lending exposures are mixed with other credit risk exposures. In order to separate specialised lending exposures, the Large Corporate sample on C 102.00 should include a type of exposure called ‘Exposures other than specialised lending’.

We would also make the following observation in relation to missing portfolios:

Missing portfolios by collateral type (C 102.00)

Increasing the completeness of the breakdowns of the “Collateral Type” value list for 102.00 can be viewed as positive even though the column “Collateral Status” already covers the unfunded credit protection clustering. In terms of the proposal to add portfolios with collateral type ‘credit derivatives’ and portfolios with collateral type ‘guarantee’ we consider this relevant only for the application of these collateral types under the double-default approach. For the portfolios under the substitution approach, the exposures are already shifted to the corresponding exposures classes, thus making it unclear how the collateral break-down is to be implemented. For these portfolios we would suggest that the ITS includes examples of how to shift the exposure according to the collateral type, in order to provide clarity. It is important to consider whether simplification can be also introduced (as in the case of the substantially overlapping information provided by the Collateral Type and Collateralization Status columns). Moreover, we suggest keeping as much as possible aligned the value lists in LDP and HPD for the same reason of reducing complexity.

We are supportive of the proposal for the annual update of counterparties (C 101.00).

Further observations

- C 102.00 & C 103.00, column 180 RWA Standardised:

The intention of reporting of Credit Risk Standardised Approach Risk Weighted Assets (CRSA-RWA) for the reference date 31 December 2018 is unclear in light of the stated intention to start such reporting simultaneously with the implementation of the revised CRSA-framework. We would welcome clarification that column ‘208 RWA Standardised’ should only be populated when the revised CRSA-framework goes live.

- C 102.00 & C 103.00, column 160 Provisions non-performing exposures

The instructions could benefit from clarifying whether this should read 'defaulted exposures'. In addition, it seems that the instructions are not consistent with regard to the naming of the columns and Annex 3 for C 103.00.

Wider/general comments on credit risk

- EBA Benchmarking template (i.e. Annex IV template C103) asks for a view of Institution portfolios as of a certain reference date for all parameters (e.g. 31 December 2017 for the exercise 2018), except for Default Rates and Loss Rates which are measured exactly one year before the reference date.

On one hand this provides the most updated portfolio picture for all parameters, but on the other the measurement date misalignment can bring to misleading conclusion if the underlying data (in particular DR vs PD and LR vs LGD) are compared without considering the existing temporal lag.

Therefore, Default Rates and Loss Rates should not be considered as a back-testing measure for PD and LGD respectively since they refer to different periods affected by clients' migrations and portfolio dynamics, and hence to different perimeters.

With regards to LGD and LR comparison also a more general topic arises due to the different underlying features for variables computation: for the LGD estimates a long default history is used, while for LR only one year observation period is adopted. The one-year-view might provide unstable and not robust results especially when only low observation numbers are available in certain portfolios making the comparison not reliable.

- The Supervisory Reporting on benchmarking portfolio supports competent authorities' assessments. In representing Institutions data towards the market it is important to ensure consistency between the way data are geographically allocated and each Institution perimeter of consolidation, i.e.: if a Banking Group operates in several jurisdictions it is fundamental to ensure a consistent allocation of relevant data in each relevant country to avoid providing misleading results. For instance, attention should be paid in not associating data of such banking groups to the Holding company country of residence, otherwise the comparison with other national peers operating mainly in one country can be highly misleading. This could be managed for instance by isolating from the Group consolidated data those "portfolio IDs" related to the country of residence of the Holding company using the counterparty country of residence as a proxy or the relevant solo/sub-consolidated level view.
- With the progressive amendments introduced in the definition of the benchmarking portfolios, the granularity of potential clusters resulting has increased significantly (currently over 114.000 for HDP). As a consequence the participating institutions will report a significant number of "portfolio IDs" with a low number of obligors and/or a low amount of exposures which might bias the values reported by banks and the benchmark results (in particular for the country-specific portfolios and for the rating distributions) if not excluded. To reduce

complexity on both side (institutions and EBA/CAs) It is suggested to define criteria of minimum materiality (in term of # of obligors or exposure amounts) to be considered for the effective reporting of a portfolio ID cluster.

- For reducing complexity without significantly impacting on the information collected it is suggested to introduce in the Regulation 2016/2070 the specification that the “benchmarking exercise” should be reported at the highest level of consolidation only. Owing to the country-specific portfolio IDs, competent authorities can rely on supportive information for benchmarking analysis at country level (based on the same contribution the local institution provide to the head of group).

The current interpretation of a large number of NCAs as for art. 1 of Regulation 2016/2070 is that the reporting should be provided at the same level of 680/2014 (eg. as for COREP/FINREP/Large Exposures and other supervisory reporting under that regulation). As a consequence a subsidiary can be requested to report the “consolidated view” and the “solo-level” view of the benchmarking exercise and to adequate the “solo-level” to local accounting principles when different from those of the head of group. Such burdens for the institutions seem not coherent with the aim of the benchmarking exercise.

As a general remark and considering the final goal of the EBA Benchmarking reporting, the application of the benchmarking portfolios at individual level for each single Legal Entity of a pan-European Banking Group may not be significant in terms of representativeness and consistency especially in the case of the Low Default Portfolios, which have a significant level of granularity due to the combination of a high number of clustering factors. The same consideration is valid for the Template 101 (single counterparties level), in which the coverage of the sample portfolio may results not significant if applied only at single Legal Entity level.

- Due to the application of the PPU as for Regulation 575/2013 the reporting of Sovereign portfolios as for LDP Benchmarking is limited to the portion of the exposures which remain IRB according to the limitations set by the art. 150. As a consequence, the benchmarking portfolio of each institution is not representative of the IRB authorized models for Sovereign counterparties and the comparability of the related clusters is affected by single institution specific factors (such as the propensity to grant credit line denominated in non-EU currencies). We suggest evaluating the exclusion of the LDP SOV portfolios from C 102.00 or an increased emphasis in the description of this limitation in the benchmarking results.
- The regulatory treatment of exposures with Institutions resident in “third country not EU Equivalent” as of CRR art. 119.5 requires their reporting as “Corporate” Exposure Classes. The ITS and related Annexes do not provide instructions on their treatment for the EBA Benchmarking portfolios. On one hand, only the COREP Exposure Class “Institution” is considered in C 102.00 for the definition of the “Credit Institution” portfolio IDs (eg. the above Banks should be excluded from the benchmarking or reported in the Large Corporate portfolio IDs); on the other hand the “Credit Institution” portfolios have geographical breakdowns which include “third country not EU equivalent” and thus seem to expect to have “Banks” reported there. We suggest explicitly requiring the envisaged treatment for Credit Institutions resident in

“third country not EU equivalent” for benchmarking purposes in order to ensure a consistent and comparable approach among the participants.

- It would be helpful if there could be clarification of the use made of the RWA amount calculated by applying the standardised approach to credit risk exposures. The calculation is burdensome and pre-empts the application of the finalised agreement of the Basel III standard.
- While increased granularity provides further information it can also have the unintended consequence of diluting information (for instance, in relation to the size of portfolios).

Market Risk

Changes to Market Risk benchmarking portfolios (Annexes 5-7):

The ITS proposes a change in the dates for the submissions agreed at TFSB level in order to facilitate a more efficient process:

- The new proposal changes the timelines for the specific steps significantly and states that the objective is to give the institutions more time to check the Initial Market Valuations (IMVs) before submission. However, the new timing reduces the overall timeframe from booking date to IMV submission date from 3 weeks to 2.4 weeks. We are supportive of moving the valuation date closer to the trade booking date as this gives institutions more time to verify the overall setup. However, we propose not to shorten the overall time between booking date and submission date for IMV.
- The new proposed timelines move the calculation dates for the risks very close to year end. As this period is one of a high demand for resources and in some banks the same teams may be involved in year-end reporting and in the benchmarking exercise, this timing is unfortunate. In addition, Competent Authorities might also prefer to have more time to follow up on any deviations they observe in IMVs. We propose to keep the calculation dates at least three weeks apart from year end i.e. not start prior to 21st Jan 2019.
- The new proposed timelines reduce the time between the calculation dates for the risks from approximately eight weeks down to approximately two weeks. Together with the significant increase in portfolios, this adds substantially to the workload of institutions and increases the risk of operational errors, because it limits the possibility for quality assurance. In addition, some institutions may use test environments to conduct the benchmarking exercise, in order to prevent any unwanted impacts from booking hypothetical trades into their live systems. Shortening the timelines will infringe on using test environments, which in themselves aim to improve quality assurance.

In order to remedy these consequences and avoid any negative impact on the output, we propose to keep a period of at least four weeks between the calculation dates and the expected submission to the respective Competent Authorities. We see two possible ways of achieving this:

- Keeping the IMV phase as proposed, i.e. having the risk measure calculation phase starting on 21 January and asking for submission by 8 March. This option would be applicable for the 2019 exercise, as it would be aligned with the usual dates for past benchmarking exercises.
- Another option is moving the IMV phase and the risk measure phase by for weeks, i.e. start earlier.

A third possibility, more suitable for exercises after 2019, in order to allow appropriate adjustment, is for the IMV phase to be moved to June with the risk measure phase in October. This timeline avoids having to respond to various exercises (e.g. FRTB QIS and CCAR) at the same time.

The ITS proposes requesting more detailed information about SVaR models and a change in the benchmarking portfolios that allows more values for supervisory purposes. This new set of market risk benchmarking portfolios has the following three-layer structure:

- The first layer consists of a set of financial instruments for which IMV ("Initial Market Valuation") shall be computed.*
- The second layer consists of individual portfolios defined by combining different instruments, for the purpose of assessing the effect of grouping instruments as well as the effect of partial or full hedging.*
- The third layer consists of the definition of the aggregated portfolios, for the purpose of assessing the diversification effects and the implied capital requirements.*

- We welcome the approach to value the instruments individually as this allows for a more granular alignment of trade bookings and more timely identifications of sources for deviations. However, the count of instruments is quite significant and might be a challenge for some institutions.
- The change in the portfolio compositions seems to be disproportionate to what is necessary to achieve its stated objectives. It would appear sufficient to only change one asset class per year rather than changing all the portfolios at the same time. Such a limited change would allow the institutions to at least check for plausibility by comparing to the previous year's results for some portfolios. This would be particularly useful in cases where staff responsible for performing the EBA calculation change during the course of a year and would help avoid operational errors. The significant change in portfolio composition makes such plausibility checks impossible.
- The significant increase in count of portfolios puts a significant additional operational burden on institutions - more than double the current cost for this exercise. We would therefore suggest limiting the increase in the count of portfolios to the minimum necessary to achieve the objectives of the exercise. In detail, we propose to:
 - Remove portfolio 8 as largely covering the same risk as portfolio 6.
 - Remove portfolio 17, 25 and 43 as they do not target a specific risk but they are also not at a sufficiently aggregate level, hence they appear to provide limited added value.
 - Remove instruments 25 and 27 from portfolio 18 to make it focus on long term EUR rates.

- Remove portfolio 26 as largely covering the same risk as portfolio 18.
 - Remove portfolio 46 as largely covering the same risk as portfolio 45.
 - Remove portfolios 51, 52 and 53 as largely covering the same risk as portfolios 44 and 45.
 - Replace portfolio 43 by portfolios 44 and 45 in the aggregated portfolios 57 and 62.
- Instruments 18, 23 and 47 are comparatively complex and may not be straightforward to price for all institutions. This leaves room for differing interpretations and hence decreases the comparable use of these instruments for the purpose of this exercise. We would thus propose removing them. That would include the removal of portfolios 7, 15 and 32.
 - Incremental Risk Charge (IRC) captures correlated migration and default events. As these events are discrete, portfolios consisting of only few issuers do not seem to produce a sufficiently granular loss distribution. Therefore, results created for such portfolios are of limited value for the benchmarking exercise. We propose to design specific IRC portfolios that are exempt from the Value at Risk (VaR), SVaR and All Price Risk (APR) calculations. Such specific portfolios should be composed out of the existing set of proposed instruments, contain at least five different issuers each and target for example:
 - Investment grade sovereign issuers - long portfolio, i.e. long bond or sold protection Credit Default Swaps (CDS);
 - Investment grade sovereign issuers – hedged portfolio, long bond hedged with bought protection CDS;
 - Sub-investment grade sovereign issuers - long portfolio, i.e. long bond or sold protection CDS;
 - Sub-Investment grade sovereign issuers – hedged portfolio, long bond hedged with bought protection CDS;
 - Investment grade corporate issuers - long portfolio, i.e. long bond or sold protection CDS;
 - Investment grade corporate issuers – hedged portfolio, long bond hedged with bought protection CDS;
 - Sub-investment grade corporate issuers - long portfolio, i.e. long bond or sold protection CDS;
 - Sub-Investment grade corporate issuers – hedged portfolio, long bond hedged with bought protection CDS;
 - Vanilla CDS (sold protection) on ITRAX 125;
 - Vanilla CDS (sold protection) on ITRAX Xover;
 - All-in portfolios comprising above.

In several instances the instrument specification could benefit from providing additional details on the assumptions, potentially in the form of “if you need to use a specific coupon, assume it is X%”. That is because relying on market standards for these assumptions, as the exercise currently requires, may lead to unwanted divergence in interpretations. This would limit the comparability of the results. We see the following examples:

- For instrument 47, it could be clarified if the notional is meant to be constant.

- For the commodities instruments 48 to 51 it should be specified whether settlement is in cash or physical.
- For the CDS instruments (52 to 67 and 69) it is worth specifying the coupon and to state that ISDA definitions apply.
- For the CDS instruments (52 to 67 and 69) we propose to use that standard maturity date 20 September instead of 19 September.
- For the CDS instruments (52 to 67 and 69) we propose to use more standard restructuring clauses: “old R” for sovereigns (instruments 52 to 57 and 69), “Mod Mod R” for EU corporates (instruments 58 to 63 and 65 to 67) and “No R” for US corporates (instrument 64).

Technical points for clarification

1. EQ Instrument 1 - index futures: In case of an equity futures should the IMV be quoted as “Theoretical Value – Strike” (expected PL), or only as “Theoretical value” (price X number of contracts)?
2. FX Instrument 47 – CCS swap: When the bank subscribe a CCS swap, it will receive (and pay) an amount of cash position from (to) the counterparty. If we consider the CCS portfolio as the whole bank, the fx cash position will remain inside the portfolio. Otherwise if we consider that portfolio only as part of the bank, the cash position will be transferred to the Treasury (as it usually happens).

In order to calculate proper risk figures in the context of the EBA Benchmarking exercise we would need to know which of the two interpretation is correct.

3. CR Instrument 52 – CDS: In the Annex 5 the doc clause of CDS instruments is not specified. In order to avoid misalignment among the institutions we suggest clearly specifying it.

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