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Consultation response

EBA Discussion Paper on the Future of the IRB Approach

5 May 2015

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on **the EBA's DISCUSSION PAPER ON THE FUTURE OF THE IRB APPROACH**. 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 summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

General Comments

AFME very much welcomes the EBA's Discussion Paper on the Future of the IRB Approach (the DP). The DP provides a clear overview of how the numerous EBA regulatory mandates and own initiative products that will affect the IRB Approach in the mid-term are interlinked, and places this work in the broader context of the international debate on the role of models in the regulatory capital framework.

Acknowledgement of the need for risk sensitivity is a welcome and strong signal

In particular, we welcome the EBA's recognition of the benefits of having a risk sensitive capital framework. While we acknowledge that there are still many moving parts at international level, we note that the EBA considers the IRB approach to be valid and appreciate the strong signal it is sending that efforts to further improve the risk sensitive approach and the comparability of regulatory capital requirements are a worthwhile investment. For its part, the industry is also fully committed to working together with regulators and supervisors to maintain a high quality, consistent and comparable risk sensitive capital framework.

A risk sensitive capital framework is necessary to accurately measure risk and allocate capital accordingly. Without risk sensitivity, the capital framework is likely to misrepresent a firm's true risk levels and may incentivise misguided origination. The less risk sensitive the framework is, the more opportunities for regulatory arbitrage are created, incentivising firms to seek higher risk assets as a means of boosting expected returns. A lack of risk sensitivity can also lead to the inappropriate pricing of risk, less lending in low-risk asset classes, less diversification across firms' portfolios and a corresponding increase in risk to the financial system as a whole.

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There are many additional benefits in having a risk sensitive framework such as the IRB approach as it creates incentives for firms to increasingly invest in improved data collection, a better understanding of risk drivers and the construction of models with superior predictive power. These models are in turn embedded in the business and used extensively to improve lending policies and risk-adjusted pricing, creating a virtuous circle.

We also wish to stress that, given differences in businesses and risk management practices, the result of a risk sensitive capital framework is that there will always be some variation in risk-weighted assets between banks. This is of course normal and to be expected as it precisely reflects differences in risk levels.

More coordination between European and international is necessary

In this context, it is important that the EBA and other relevant European institutions engage with the international regulatory community to ensure that the risk-sensitive nature of the Basel framework is confirmed and maintained. As the EBA rightly recognises, the changes under consideration to increase comparability of capital requirements will be burdensome and costly. Therefore, while the DP is indeed welcome as it affords the opportunity to reflect on how best to sequence and implement the multiple regulatory changes being envisaged, a consistent approach between the development of the international framework and EU requirements is essential if this work is ultimately to be worthwhile and successful. This is particularly important as the EBA regulatory changes covered by the DP are likely to lead to material changes in models and will require firms to make significant investments. The lack of clarity on how international developments with affect the (EBA revised) IRB framework means it is extremely difficult for firms to make such investment decisions.

While we are supportive of the EBA's direction, we are concerned that there is risk that their objectives will not be met if the issue of historical data is not addressed adequately. Changes to rules, supervisory and firms' practices are all very well but will not deliver the desired reduction in variability if they are based on data that has become unstable and of poor quality as a result.

Industry is committed to achieving the necessary improvements

We appreciate the EBA's recognition that the increase in comparability requires improvements to be made in several areas. We fully agree that it should not only involve regulatory change, but also increased transparency on the part of the industry, harmonised implementation and improved consistency on the part of supervisors.

We are willing to engage and cooperate extensively to achieve these necessary improvements and we think that significant progress has already been made. For instance, the key areas where banks' risk modelling practices diverge have been identified and industry has made extensive recommendations to adopt common approaches where possible, effectively harmonising modelling choices[1]. We also continue to engage intensively on multifaceted technical issues that require frameworks that are comparable between firms but that reflect the specificities of their businesses, portfolios, risk management processes and recovery strategies (i.e. are risk sensitive)[2].We look forward to continued, constructive dialogue of this nature and our response to the questions raised in the DP below includes a number of concrete suggestions that we encourage the EBA to consider.

[1] IIF RWA Task Force final report, including approximately 100 recommendations for harmonisation of modelling approaches

[2] See AFME's Downturn LGD Discussion Paper as an example

The way forward is to find the right balance between comparability and risk sensitivity

Industry does however have an overarching concern that harmonisation efforts appear to be solely headed in the direction of increased prescriptiveness . While we understand the EBA's concerns on allowing too much flexibility in the context of non-risk based RWA divergence, it is still necessary to strike an appropriate balance between having comparable outcomes, with the need for a system that caters for the wide variety of situations that firms encounter in practice (i.e. a system that is risk sensitive). In our view, the EBA can reach this middle ground by setting frameworks that guide firms' approaches to modelling, thereby ensuring that firms address all the relevant risks they face and that are relevant to their business. With firms using these same guiding frameworks, their modelling approaches will be consistent, yet they will not have to adopt requirements that do not reflect the true risks of their business. We would also strongly encourage the EBA to test these frameworks and their RTSs/Guidelines on real life data before issuing proposals for consulting. AFME and its members are willing to help as much as we can in this respect.

We are also very much supportive of the EBA's objective to harmonise supervisory practices; its recent work on the SREP and the IRB assessment methodology, together with a number of the forthcoming RTSs and Guidelines discussed in the DP, are welcome steps in the right direction. However, in the context of SREP and internal models assessment and validation, care needs to be taken that supervisors do not interpret some of these provisions too narrowly as this could result in the requirement for automatic corrective actions without providing sufficient room for judgment-based decisions. Firms must be given the possibility to explain why slight deviations from an internal or external standard exist and could in fact be fully appropriate for a particular portfolio given the broader context of a model and any other relevant factors.

Responses to the Consultation Questions

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

First and foremost, while we respect the EBA's initiative and positive attitude towards risk sensitivity, which is indeed extremely welcome, as a matter of priority we would nonetheless encourage coordination with the Basel Committee which should include a clear, published alignment of timelines to avoid inconsistency, or duplication of efforts. In particular, it is not clear how the revision of the both the standardised approach for credit risk and the IRB by the BCBS will be taken into account.

We are also concerned that the DP does not provide more information on, or cover the timing of, issues that will likely require Level 1 changes or that could otherwise affect the EBA's IRB programme as set out in this DP. This includes PPU and roll-out plans, the alignment of exposures categories between the Standardised and IRB Approaches and the issue of so-called Low Default Portfolios (LDP).

More generally, there is the ongoing question of the reliance of capital requirements on internally modelled approaches. Our strong recommendation would therefore be for the EBA to align its programme of IRB repair with the BCBS's work.

This being said, we agree that the definition of default is one of the fundamental building blocks in internal model development, and that any harmonisation efforts are best directed here in the first instance. We also agree that any calibration of LGD and PD parameters must be undertaken subsequent to changes made to the definition of default, but should be implemented simultaneously because of their interlinked nature.

We also agree with the proposal to examine further harmonisation of CRM standards in the last stage of EBA's work programme. More specifically the EBA DP mentions the Internal Models Approach and master netting agreements. However, there is an obvious overlap with market and counterparty credit risk (on repo-style transactions) which must also be considered carefully, especially in view of international reforms on the CVA charge, Fundamental Review of the Trading Book and Standardised Approach for Counterparty Credit Risk.

Lastly, we wish to point out that while almost all of the EBA's planned RTSs related to risk parameters are covered by the DP, the RTS on the specification of conditions that competent authorities shall take into account when determining higher minimum LGD values (CRR Article 164§6) is not mentioned – we would welcome clarification on the EBA's timing intentions with respect to this RTS and how they view its inclusion in the context of their IRB work programme.

2. What would you consider the areas of priorities?

Prioritisation should be given to coordination at the Basel level to ensure that harmonisation does not only take place within the EU, but within other key markets as well. Large cross-border institutions that are present in a number of different jurisdictions would depend on this consistency and, indeed, this consistency will only serve to strengthen the broader goal of reducing RWA variance throughout the financial system.

The EBA has posed several questions specifically targeting implementation challenges, in particular relating to the adjustment of historical data. We appreciate this focus and prioritisation because, indeed, back populating historical data and recalibrating the full suite of internal credit risk models will be a heavily burdensome exercise requiring a long phase in period.

Questions 5 and 6 relate specifically to the adjustment of historical data so we will respond in more detail to these points. However we would already like to highlight the importance of considering the timing of this as key area of priority. In this regard we believe that the proposed 2.5 year implementation period, following finalisation of the EBA RTSs and Guidelines, is unrealistic (see also below question 3).

As already mentioned in our overarching comments, prioritisation should also be given to testing each of the EBA's proposals on real life data. A number of the proposed RTSs and Guidelines have the potential to be very far-reaching and require significant change to bank's back office risk systems including data and credit engines. The front office will also be impacted by any changes related to day-to-day relationship management. Any proposal should therefore undergo a thorough 'road test' based on real data to ensure that the desired objective, reduction in non-risk based RWA variance, is achieved.

Moreover, recognising that diversity and variance in the financial system is healthy, and that differences in RWA outcomes are normal and to be expected, the EBA should consider what its appetite, and the appetite of the regulatory community, is for such variance.

It is very challenging to prioritise one set of internal modelling parameters over another. Each element provides a different, but equally important, piece of information which feeds into the final RWA calculation.

This being said, the proposed order of major topics in the DP seems logical. The first priority refers to default which is the key point in models and therefore for harmonisation. Then, risk parameters with LGD before PD because more new requirements are expected in terms of LGD. Lastly, CRM because of fewer changes presented by EBA - they relate to minor areas and not the whole CRM framework.

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3. Do you consider the proposed timeframe reasonable? In particular do you consider reasonable the proposed timeline for the implementation of the changes in the area of: a. definition of default; b. LGD and conversion factor estimation; c. PD estimation; d. treatment of defaulted assets; e. CRM?

The overall timeline proposed by EBA—2.5 yrs for the implementation of changes to Definition of Default, 2 yrs for the implementation of changes to LGD and PD estimation and 1 yr for the implementation of changes to the CRM framework—is overly ambitious and unrealistic.

Again, questions 5 and 6 relate specifically to the adjustment of historical data for the Definition of Default, therefore our more substantive comments relating to this point are found below. We would already note however that, as rightly stated by the EBA, adjustments to the definition of default resulting in the need for any retroactive updating of historical data will take longer than the other phases.

Moreover, each individual phase is likely to take longer that predicted by EBA (and in particular for the definition in default which will be the most time consuming).

As specified previously in AFME's response to the default materiality threshold RTS, this specific change could take approximately 3-4 years, if it were one change carried out to one model in isolation, i.e. without taking into account changes to the potentially hundreds of models that a large, international institution may have, and without considering the other required model adaptations in the pipeline. Given that every subsequent phase of change depends on the preceding phase, the entire timeline proposed by the EBA will need to be lengthened accordingly.

The required total implementation time also obviously depends on the number of models in use in a firm (several hundred models can be used in a multi-product, multi-jurisdictional bank), how far back firms have to apply the new requirements and make adjustments and the depth and length of the supervisory approval processes.

Reiterating some of the comments already made in our response to the default materiality threshold RTS, we think the EBA and NCAs can help alleviate the burden for firms significantly by considering various approaches to timing of implementation (and historical data adjustments):

- For instance, one way of dealing with the level of complexity firms will face, and the CRR requirement for 7 years historical data, would be to allow firms to phase in the changes so that full implementation is achieved after 7 years, rather than requiring firms to apply the new definition retrospectively.
- A very important contributor to the required time for implementation will be obtaining the necessary approval from NCAs who will experience a surge in demand for new approvals at approximately the same time from all IRB firms in all Member States. A pre-defined approval calendar should be set up with the supervisors – together will the roll-out plan – to enable the banks to anticipate and organise the changes.
- We would also suggest that any timeline for implementation be phased in, addressing those models which are most material in the first instance. A plan could be established with the supervisor of each entity:
    - Based on the firms' internal model cartography, priority areas covering the major/material models/exposures of the group should be identified;
    - Changes should be implemented to these areas first, covering all the required parameters;
    - Changes on the remaining models should then be implemented sequentially.

We therefore suggest that the ultimate implementation period will in practice have to be agreed between firms and their supervisors on a bilateral basis. This will also have to take into account forthcoming proposals from the BCBS to avoid multiple change processes having to be carried out in short succession.

On balance, we feel that this implementation period should be at a minimum 5 years, excluding the time that would need to be allocated to the supervisory approval process, and on the condition that firms are allowed to use proxies to complete their historical data (see response to question 5 below).

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

We think most of the aspects related to the definition of default are addressed in the proposed RTSs or guidelines. We understand that the following aspects will be treated:

- Days past due : start day and counting of days past due
- Materiality threshold (please refer to our response to RTS on this issue)
- Number of defaults through the multiple default concept
- Return to non-default status criteria
- Forbearance: harmonisation of definition to increase consistency with ITS on supervisory reporting

We encourage EBA to also examine the following topics:

- Convention for incoming payments (FIFO or LIFO)
- Scope and use of technical defaults
- Contagion: internal and external
- Distressed restructuring
- Selling credit obligations at a material economic loss

We also insist on the need to take expert judgment into account. As far as defaults are concerned, decisions might rely on expert judgment, especially when dealing with non-retail counterparties, as this requires deep knowledge of the portfolio in line with internal risk monitoring policies and economic reality. Requirements that are so narrow as to completely exclude human judgment could perversely impede sound practices, use tests and the propagation of a sound "risk culture".

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

In this area, the objectives of comparability and simplicity should be a priority. Consequently, there is a need for balance between these objectives and the CRR requirement for sound historical data.

Given the inherent difficulty of the IRB repair exercise, the reliability of data used to estimate risk parameters and build internal models could be affected, and hence the comparability of the results among institutions may be too.

We think that the challenge is therefore to find the best trade-off between the length of the historical data period and the reliability of this information. Requiring adjustments over lengthy periods where the data will become significantly biased will not improve the comparability of RWA outcomes. Instead, the objective should be to avoid misleading risk parameters (which would be damaging for institutions' business and the propagation of a sound risk culture), even if this means that the historical data period is somewhat below CRR requirements.

As stated in our response to question 3, the ideal manner of dealing with this is that firms implement the changes prospectively so that full implementation is achieved after 7 years, rather than requiring firms to apply the new requirements retrospectively or to make adjustments.

As an alternative, and considering all of the above, we think a reasonable transition period should be made available to banks in order to rebuild consistent historical series. Existing (and validated) parameters (i.e. PD, LGD based on existing definitions of default) should be grandfathered over a sufficient time period. Due to the requirement to use a minimum depth of 5 years of data, we could estimate that 4 years of transition would be the maximum duration of this transition period. A parallel run over a limited time period would be another possibility, but it would have to be assessed with caution owing to the difficulty and cost to operate two distinct operational and IT systems.

Another approach could be to make use of a representative sample of data to implement the requirements of the RTSs and Guidelines, evaluate the impact of the change and assign proxies to the remaining data. To control for poor data quality, an estimation error would have to be assessed and corrected for with a certain margin of prudence.

To ensure harmonisation and comparability of approaches, firms could share information on their model performance in a common manner (see below answer to question 17 for further information).

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

In the majority of cases, we do not think it would actually be feasible to rebuild historical data to take the threshold into account retroactively. The workload would be immense: data collection, change management, changes in parameters and rating systems as well as IT development.

Moreover, it is important to note that business processes are aligned to a particular definition of default. Therefore, assessing past performance on a definition that was not in place at that time is unlikely to be a reliable indicator of future performance.

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

The impact and materiality of the changes described in section 4.3.2 will depend on the concrete proposals and requirements of the EBA. At the current stage there are too few details available for us to provide a detailed assessment. Once again, the full extent of impacts will also depend on how decisions taken at international level are integrated into EU legislation.

Lastly, it is important to stress that the impact of the forthcoming changes will also be highly dependent on NCA's expectations and supervisory approaches. For instance, if proxies are not accepted in the reconstruction of historical data, the impacts will be extremely important. In this context, we would encourage supervisory authorities to exercise careful judgement with respect to the application of Commission Delegated Regulation (EU) n°529/2014 on assessing the materiality of extensions and changes of the Internal Ratings Based Approach and the Advanced Measurement Approach.

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

AFME very much welcomes the EBA's initiative and notes that work done by industry in the same spirit already addresses a lot of the issues mentioned in this discussion paper.

In general, the weaknesses and divergences identified should be reduced thanks to provisions that will limit the technical differences in the quantification of risk parameters, such as the estimation of the

default rate where it will be clearly explained how to estimate the numerator and the denominator or the use of the same type of weights to estimate LGD.

Nevertheless, we wish to recall that harmonisation should not be an impediment to the maintenance of risk sensitive models that reflect internal processes and policies, as well as management practices. As explained above, we are also concerned that data quality issues could hamper rather than improve comparability, which would be contrary to the objective being sought.

We also insist on the need to test the forthcoming proposals, before they reach final stages, on real life data sets to ensure their practicability and that they will lead to an effective reduction in non-risk based RWA variance. Industry is willing to share data with the EBA for this purpose.

Lastly, we wish to reiterate that the unknown, further changes that may arise from international level discussions also create an extremely uncertain and unstable situation. In particular, international supervisory divergences will remain, implying that a certain degree of RWA variance will be retained depending on the jurisdictions under comparison.

This current lack of coordination is a missed opportunity that may prove costly, not only to firms who will likely have to make multiple, unnecessary and costly sets of changes to their model, but that could also impact their ability to allocate capital appropriately with undesirable economic consequences.

We therefore advise and encourage the EBA to promote the approach it has taken with the publication of this DP within international fora, including the BCBS and the G20. Clear timetables and detailed descriptions of the intended coverage and content of these forthcoming proposals are essential to ensure that change is managed and undertaken in a comprehensive, efficient manner.

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

For a comprehensive overview of other aspects that should be addressed and that we support, we refer the EBA to the response of the IIF to this consultation. Nevertheless, we wish to stress the following points in particular:

- We would be in favour of the EBA addressing the issue of conservatism or margins of prudence. Industry has been considering various approaches to how practice in this area can be harmonised. We would welcome the opportunity to discuss this topic in more detail with the EBA.
- The issue of low default portfolios is crucial and needs to be given very careful consideration. We provide further views on the issue of below in our response to question 20.
- Additionally, we wish to stress once again that should the EBA issue proposals on these matters in the guidelines, they should ensure that any requirements are tested on real life data examples to see if they are i) feasible and ii) to ascertain impacts prior to exposing the proposals for consultation. While we recognise that this might lengthen pre-consultation phases, we do consider that it would vastly strengthen the quality of the regulatory process and avoid the implementation of proposals that may be conceptually appealing but turn out to be difficult to operationalise, potentially requiring further regulatory adjustment down the line. AFME and its members are very much willing to help the EBA in this respect by sharing data that can be used for these purposes.

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10. Do you have dedicated LGD models for exposures in default that fulfil the requirements specified in section 4.3.3.(ii)?

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

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

We respond to questions 10-12 together.

The current regulatory guide lines on LGD for exposures in default (LGD D) are still vague. Knowledge sharing between institutions shows that methodologies used so far for LGD D range from no specific model (ie: use of LGD in bonis model directly applied to exposures in default) to very specific models (being LGD in bonis including point in time effects, or specific LGD D model).

The EBA's Guidelines on the matter should propose a more precise and unified view and restrict diverging practices by banks for the sake of simplicity and model comparability, focusing on ELBE, margin of prudence and provisions and articulate those in an LGD D formulation.

We would also welcome clarification on the hierarchy of various LGD values.

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

The primary impact to consider is that meeting the roll out plan is dependent on models being approved for use. Therefore, competent authorities wishing to lay down stringent roll out plans in terms of proportion of assets ultimately on the IRB approach or timescales will find themselves receiving applications where the primary goal of model implementation is to meet roll out plans rather than strong risk management reasons.

At this stage, it is difficult to provide additional details as we would require more information on the content of the forthcoming proposals. However, in order to assist the EBA in its reflections, we have provided the outlines of an illustrative "project management" type schedule that could be used to assess the impact of the changes and roll out plans as a guide so that the EBA has an overview of the complexity that is involved for each firm. The multiple dimensions and interactions of the drivers listed in this table clearly confirm the need for supervisors to adopt a proportionate approach when assessing the appropriateness of roll-out plans.

Moreover, it will be essential to retain some degree of flexibility with respect to IRB coverage requirements which in practice may not be attainable; possibly because it is not always economical to use the IRB approach (e.g. for very immaterial portfolios) but also for reasons that are beyond a firm's control, such as cases where risks are deemed to be "un-modellable". We encourage the EBA to keep the need for this flexibility in mind, including when engaging in international fora.

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Illustrative ROLL-OUT Impact Assessment							
Drivers	Portfolio	Materiality	LDP	Data	Tools	Processes	(...)
Definition of default	SME, Corporate, Sovereign, (...)	Y/N €	Y/N	Available: Y/N History: 10y/5y/2y...	Impact assessment (ranging from none to high)	Impact assessment (ranging from none to high)	
PD models	# of models						
LGD models	# of models						
LGD defaulted assets							
Downturn LGDs							
CCF models							
CRM							
Non-modellable risks							
(...)							

We feel that it would also helpful to arrange preliminary assessment contacts and discussions between banks and regulators before final decisions are reached roll-out plans.

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

The impact of the rules in section 4.3.5 will depend on the specific organisation structure and/or allocation of responsibilities within each institution. As stated in our response to the EBA's draft RTS on the IRB Assessment Methodology, we agree in principle with the required independence of the validation function. This being said, we wish to stress that mandatory organisational independence would go beyond the requirements of the CRR and, that where an organisation procedurally ensures that different staff is responsible for the validation and development functions, this is completely adequate to ensure such independence.

Independence can also be achieved through the use of various governance structures, including separate reporting lines, covenants, or combinations of both, the precise organisation of which should be left up to the firm to determine. Similarly, the level of hierarchical responsibility and the seniority of reporting lines may vary depending on the size and nature of the firm.

In order to avoid introducing a level of prescriptiveness that may force unnecessary organisational change, we suggest that when finalized, the RTS on the IRB Assessment Methodology provide for account a 'comply or explain' approach in which an institution that has come to a different organisational structure from the one set out by the supervisors has the opportunity to explain why it has chosen that solution and explain why it is an effective approach that meets the required objectives.

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

The DP considers the RTSs on CRM issues to be of a lesser priority. We agree with this because those RTSs are very specific. Nevertheless, the CRM framework is of utmost importance and we think that particular consideration should be given to expanding the scope and granularity of eligible credit risk

mitigants and their recognition under Foundation IRB treatment. This would also need to be carefully coordinated with work being carried out at BCBS level, not only on the CRM IRB framework, but also with respect to improving the risk sensitivity of the revised Standardised Approach for Credit Risk.

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

For an extensive overview of other existing discrepancies, we refer the EBA to the response of the IIF.

The following issues however stand out (and can be considered to be other sources of undue RWA variance):

- The imposition of various exposure or parameter level supervisory floors by different authorities globally
- The double validation of internal models by home and host authorities
- Differences in the materiality threshold for defaults between EU and non-EU jurisdictions

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

AFME and its members are strong supporters of transparency in general and consider in particular that more transparency will foster greater understanding of internal models.

We therefore view disclosure as being fundamental to reinforce the credibility of internal models and fully appreciate the need of investors, analysts as well as external auditors to be able to understand institution and model performance. At the same time, a trade off does have to be reached between these needs and the extent of information disclosed so that this information is i) accurate, ii) understandable and iii) does not lead to the divulgence of proprietary or business sensitive information.

We do not think that full publication of benchmarking exercise results on the EBA website will necessarily achieve this goal and would recommend instead that the EBA consider the disclosure of benchmarking results only in so far as they are not attributable to (or do not lead to the identification of) individual firms.

As explained in our response to the EBA's RTS/ITS on the benchmarking exercise, we think that there are a number of flaws in the construction of the benchmark exercise. The results therefore need to be interpreted with extreme caution and are likely to only be fully understandable to NCAs who benefit from a boarder context. As a simple example, these exercises rely on hypothetical portfolios that have little to do with institutions' real businesses and indeed, their main aim is to help NCAs and the EBA perform comparisons for regulatory purposes.

Moreover, publishing complete results will likely result in information overload: it will increase complexity of available information and possibly spread confusion in external stakeholders' mind, with the risk of misleading interpretations and analysis. In this context, we recall also that disclosures have have already been increased both quantitatively and qualitatively in the last few years with the development of Pillar 3, the EDTF process, the various stress-tests disclosures (EBA-ECB, DFAST and CCAR) and the EBA Transparency Exercise. It will also be difficult to establish links with Pillar 2 disclosures and, as result, may raise more questions than answers regarding an institution's performance.

We wish to express our disagreement with the statement that that market participants are largely concerned about the opacity of IRB model:

- This may been the case in 2008-2009 for some specific asset classes (essentially securitisations or structured transactions), but we think that the already improved disclosure and the adequate

actions of regulators and supervisors (supervisory review, comprehensive assessments, stress tests, etc.) have since largely reduced these concerns and increased the confidence in the soundness of the banking sector. For instance, the joint action of the EBA and the ECB to set up the Single Supervisory Mechanism in 2014 has been a real milestone.

- In our view, the main concern of market participants today is paradoxically more the uncertainty created by the lack of coordination and extent of numerous regulatory bodies' initiatives on this issue, rather than any fundamental doubts on the quality of banks' assets or their trust in RWAs.

We believe that a large, if silent, majority of market participants is rather asking for clear signals of confidence from regulators and supervisors after their assessment of banks IRB models. We also support this.

Disclosures of ex post margins of conservatism – an industry proposal for discussion with the EBA

We would also recommend consistent disclosure of the performance of models based on ex post margins of conservatism. Margin of conservatism is a relatively broad concept, covering various scenarios. It is usually understood as an ex ante concept, defined and included in model calibration. However, it can also be an ex post notion defined and observed when assessing models and backtesting their results. There are several ways to measure model performance based on their ex post conservatism, and industry would be willing to propose a simple, standard way of doing so. We are currently in the process of developing a number of indicators that could be used for this purpose and would welcome the opportunity to discuss the concept of ex post margin of prudence with the EBA further.

Lastly, we would like to take this opportunity to recall that we strongly disagree with the BCBS project to require banks that are using the IRB Approach to disclose hypothetical capital requirements according to the Standardised Approach for credit risk. This approach is too simplistic and will again create confusion in external stakeholders' minds, leading to irrelevant questioning and complex debates which would be difficult to solve without the disclosure of proprietary or confidential information.

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

We are concerned that the EBA's project to anticipate the BCBS disclosure for EU banks would create an unlevel playing field with non-EU banks.

Institutions will be required to publish information consistent with the BCBS disclosure requirements as at January 2015 from end 2016. Any additional ad hoc disclosure should not be made mandatory before the enforcement of the BCBS disclosure and the implementation of all new regulatory requirements. One should not assume this represents a limited burden on institutions which already have to implement an unprecedented number of regulatory changes and disclosure requirements in a very short timeframe.

Moreover, we wish to stress that for any ad hoc disclosures to be relevant, they have to be consistent with BCBS requirements. It is also important that disclosed data adds value to regulatory disclosure. For example, the Transparency Exercises have indeed provided harmonised, easy to access information on RWAs to users. However, their effective use by analysts and investors seems to have been rather limited in practice. It is important that the EBA keep in mind the fact that high granularity may not necessarily

always be very useful to market users, but could provide valuable information on market shares and customers to competitors.

Beyond this, we do support the EBA proposal to issue guidelines for reporting ad hoc information and would suggest that this be done by leveraging the COREP and FINREP

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

We support enhanced mandatory disclosure principles as improvement steps towards greater simplicity, comparability as well as for risk sensitivity. EBA proposals should align with the BCBS revision of Pillar 3, advanced proposals by the EDTF and by the IRTF work of the IIF. The main principles should be to impose that all institutions disclose measurements based on standardised tables, layouts, scopes (asset classes, portfolios), granularities (risk ranges or rating), ex-ante calibrations and observed, ex-post realisations. Those disclosures should also be accompanyied by normalized narratives which allow for unambiguous understanding of the measurements disclosed, and that facilitate comparability between institutions.

Our members would generally support greater transparency and harmonisation of IRB reporting, however the need for specific changes will only become evident as a result of the other changes to the IRB framework as described elsewhere in this Discussion Paper.

In addition to any changes required as a result of an amended IRB framework, some members also request a greater delineation of disclosure for Default and Non-Default assets, specifically the disclosure of EL and Provision values within COREP.

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

Data limitations can pose an important challenge to the estimation of PD and LGD parameters in general, and of LGD parameters consistent with economic downturn conditions in particular. We are aware that there is currently an on-going discussion within the BCBS as to whether firms should be allowed to model such parameters, particularly for certain portfolios known as low default portfolios (LDPs) where a given institution may possess relatively little data on an individual basis or whether minimum supervisory LGD levels, or LGD floors, should be used in relation to such portfolios.

As demonstrated in AFME's LGD Discussion Paper[3], LGDs are an essential component in correctly assessing risk and risk sensitivity. A risk sensitive capital framework cannot solely be focused on PDs. However, the replacement of firms' LGD estimates with minimum supervisory LGD parameters that become binding constraints would i) misrepresent and disguise actual risk and ii) incentivise misguided origination for banks. Indeed, with actual levels of risk not being recognised, firms may instead be incentivised to favour products or counterparties with lower recovery prospects and higher risk but potentially generating higher returns.

Moreover, under such circumstances, firms will have less incentive to take on collateral (as its mitigative effect will not be reflected in their LGDs) and will favour unsecured lending instead, resulting in a distorted view of their actual risks. Ultimately, this will lead to an increase in risk as well as less diversification across a firm's portfolios. This is contrary to supervisory objectives (and appears to be somewhat contradictory with stated intentions to consider a wider and more granular recognition of collateral, for example in the IRBF approach) and will instead lead to herd behaviour that will ultimately make the financial system more unstable.

[3] As presented to and shared with the EBA

It is also misleading to think that calibration risk can be addressed this way. Supervisory LGDs are not immune to model or calibration risk, nor are they necessarily a better reflection of what the appropriate level of own funds should be for such portfolios.

Additionally, the imposition of LGD floors will reduce incentives for firms to put improved systems in place to capture loss data and invest in further building up their understanding of losses and recoveries. Instead of resolving data issues, the introduction of floors is more likely to perpetuate data scarcity and will discourage the risk management of "data poor" portfolios

Lastly, unless fully coordinated, far from improving differences in RWAs, different floors, introduced at varying speeds by regulators in different jurisdictions for different portfolios will reduce comparability between RWA outcomes and potentially create level playing field issues.

We therefore consider that there are other routes to be pursued to address issues associated with a perceived lack of data:

Expert judgement: Regardless of data quantity and quality, risk calibration is not and can never be a purely statistical exercise. While expert judgment should never be relied upon solely either, it is important to recognise and allow business expertise to fulfil its important role and in particular to accept that it can be a robust supplement in cases of data scarcity.

Collateral management: In order to improve both data quality and quantity, a greater focus on incentives should be exercised by regulators to encourage data capture on all asset classes. This should be directed towards collateral management, including collateral registration, improved data collection, market valuations and documentation requirements. As pointed out above, we are concerned that collateral taking will be disincentivised under supervisory imposed LGDs. However, not only does improved collateral management lead to improved data quality and LGD modelling, collateral is crucial in the survival of a firm in crisis.

Data pooling: Data pooling is a powerful tool that can be used to overcome data scarcity issues occurring at the level of individual firms. The introduction of the risk sensitive Basel 2 framework has seen the development and promotion of data pooling exercises, with pools now being widely available from commercial, public and non–profit organisations such as well-established rating agencies, industry groups and public sector delinquency registers. They should be encouraged both in capture and in use.

By drawing on data from data pools, firms can build up models that are tailored to their businesses and portfolios even when data is scarce at the individual firm level. In this respect, data pools are a tool similar to internal databases, providing information that firms can harness to build representative, firm-specific samples by restructuring the pooled information according to drivers that are relevant to the firm in question. Even in cases where the pooled data may be deemed not to be sufficiently representative or comparable to a specific firm's internal portfolio, a firm can still compare its internal calibrations with the multibank average from the pool and explain any differences.

The industry would be keen to discuss in more detail with the regulatory community how firms can harness and adapt pooled data to their specific portfolios. More specifically, we recommend forming an expert group across banks and regulators to engage with vendors or other data pooling initiatives to ensure consistency and transparency on the use external data and to issue guidelines on whether and for what purpose such databases are "fit for purpose".

Floors should be a last resort, and if they are necessary, calibrated collectively using pooled data.

To avoid the disadvantages set out above, supervisory LGD floors should only be established as a last resort solution, and even then, as temporary measures. If they are needed at all, they should be set at

different levels for different portfolios (instead of a single overall floor), taking into account the different risk characteristics of various portfolios. In order to make them less of a blunt instrument, they should also be based a collective assessment using data pools from different sources.

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

We do not see this as an excessive concern where oversight is provided by the competent authority.

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

Yes. This should be done at the same time as the rest of the EBA's IRB work programme.

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

n/a

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

n/a

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

The DP briefly discusses in §186 (credit risk mitigation section) the possibility of removing the so-called "double default" methodology. We are however strongly in favour of keeping this methodology in the future framework and would welcome further engagement with the EBA on this issue.

The "double default" methodology aims at capturing the lower risk of an underlying exposure hedged by a protection provider, based on the simple assessment that the risk of both a borrower and a guarantor defaulting on the same obligation and at the same time may be substantially lower than the risk of only one of the parties defaulting.

To this extent, the BCBS developed in 2005 sound treatment to capture this lower risk without introducing any new risk parameters or complexity through new internal models, but simply based on a cross-utilisation of the borrower and the protection providers' risk parameters (PD, LGD).

In our view, the "double default" treatment addresses a real economic situation where the combined risk of loss for a lender is less than the risk of only one counterparties defaulting (the borrower or the protection provider). Furthermore, the treatment defined by the BCBS does not introduce complexity and should in our view be maintained in order to encourage financial institutions to hedge some of their exposures, even those benefiting from a favourable internal treatment. To this extent, "double default" is an interesting tool for managing credit and concentration risks under both Pillar 1 and Pillar 2 frameworks. More generally, we think that it is crucial to maintain the substitution approach in the regulatory framework.

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