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Finance for Europe

Consultation response

PRA's CP 12/14 CRD IV: updates for credit risk mitigation, credit risk, governance and market risk

26 September 2014

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on **the PRA's CP12/14 CRD IV: Updates for credit risk mitigation, credit risk, governance and market risk**. This response addresses specifically the **PRA's credit risk proposals (IRBA permissions for certain exposure categories)**.

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.

The advantages of risk-sensitive capital requirements must not be ignored

AFME and its members are well aware that international level discussions on the need to bring about improvements to the risk-based framework for capital requirements are taking place. We stand ready to assist policy makers at international, European and national levels, as appropriate, in this debate.

Nevertheless, the industry wishes to reiterate the reasons behind our continued support for risk-based capital measurements in this response. We fully recognise and support supervisory objectives to ensure that capital requirements are conservative, consistent and comparable. At the same time, however, it is crucial that the right balance be struck between these objectives on the one hand and the level of risk-sensitivity of capital requirements on the other. Risk-based requirements are an important tool for supervisors to sensitize banks to their risk levels and ensure that risk is effectively managed. As such, risk-sensitive requirements can precisely help supervisors achieve their objectives.

AFME therefore asks the PRA to bear in mind the tangible benefits of maintaining as high a degree of risk-sensitivity as possible in the capital framework. It is also in this context that we invite the PRA to review our concerns on their policy decision to no longer grant AIRB permissions and replace existing AIRB permissions for exposures to central governments and central banks, public sector entities and financial sector entities with FIRB permissions by mid 2015.

Our concerns are briefly set out below and are followed by alternative suggestions we encourage the PRA to consider.

AFME has a number of concerns with a blanket FIRB application to these exposures

Firstly, the PRA's decision pre-empts the outcome of international-level discussions which are still at early stages and where no public consultation has taken place yet. Moreover, although we understand that concerns have been voiced in certain quarters, a blanket application of the FIRB approach to the above exposure categories is, in our view, contrary to the spirit of the CRD4. The CRD4 remains the relevant legal framework and requires national competent authorities to encourage institutions to develop internal credit risk assessment capacity and increase their use of risk sensitive approaches for calculating capital requirements[1]. We also consider that this change could be seen as being contrary to the objective of achieving a single EU rulebook. As such, it may increase fragmentation and render the outcome of banks' models less comparable between jurisdictions. In this context, we note that efforts to understand reasons behind the variability of RWA outcomes have identified differing national implementations of the capital framework as being a major source of perceived RWA inconsistency. In conclusion, we are not convinced that the timing of the PRA proposals is sufficiently in sync with other ongoing work, nor do we think it would be beneficial to introduce specific national regimes at this point in time.

We are also unclear as to what the basis for the PRA's assessment that firms "are not able to demonstrate compliance with CRR Article 179(1)(a)"[2] is. This article of the CRR states that "the less data an institution has, the more conservative it shall be in its estimation". A perceived lack of data therefore does not necessarily imply that the use of the AIRB should be disallowed. Consequently, we would appreciate a more detailed communication on how the PRA has arrived at its conclusions. It would be disappointing if the industry's collective efforts to improve risk understanding and information sharing, including on low default portfolios, are not be recognized by the PRA (see below for a practical example of such efforts).

We also feel it is important to stress that a default requirement for the FIRB approach will still expose banks to calibration risk because supervisory LGDs and conversion factors are not immune to model risk nor are they necessarily reflective of what the appropriate level of own funds should be for such exposures.

Last but not least, it is our understanding that the impact of the PRA's approach would be important for firms using the AIRB. We therefore think that it would be preferable to adopt, or at least consider the merits of, another approach before having recourse to the FIRB approach. We suggest a number of alternatives the PRA could consider below.

Alternatives to the proposals

In AFME's view there are a number of superior alternatives to a blanket FIRB application, both in terms of prudence and risk sensitivity, that could address concerns in the area of LGD or EAD estimation for sovereign, PSE and financial institution exposures:

- The PRA notes an "industry wide lack of default data" for these exposures. We wish to point out that, regardless of data quantity, risk calibration is not and can never be a purely statistical exercise. To be clear, this does not mean that judgment considerations should ever be relied upon solely either. We are simply saying that we feel it is important to recognise the role of business expertise which is necessary in all situations and can also robustly supplement data availability.

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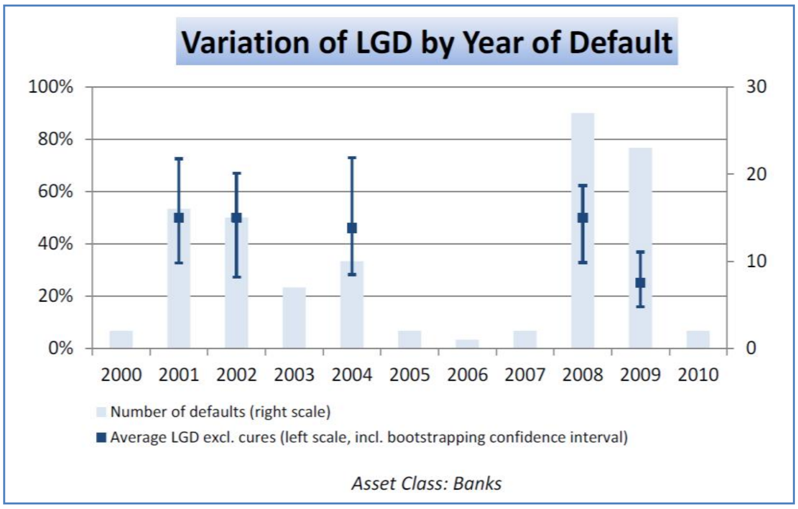
[1]CRD Article 77 (1)

[2] See PRA CP 12/14 para 3.3

- Secondly, there are a number of tools available to overcome data scarcity issues at individual firm level. For example, data pooling across firms has been developed and promoted since the introduction of the Basel 2 framework. Data pools are widely available from commercial, public and non–profit organisations such as well established rating agencies, industry groups and public sector delinquency registers.
- By drawing on data pools, firms can create models that are far more risk sensitive than the FIRB framework. These data pools are wide-reaching and a significant resource. For example, one industry group for credit data pooling, the Pan-European Credit Data Consortium (PECDC), brings together data for 900 defaulted loans from the financial institution asset class. The chart below provides an illustration of the available data[3]:



For these types of exposures, we would encourage the PRA to turn to data pooling to remedy any perceived data issue rather than imposing a default FIRB requirement.

- Rather than removing the recognition of modelled LGDs entirely, appropriate LGD floors, developed on the basis of joint public and private sector research and using all available industry data (pooling), can be introduced into the AIRB approach. The advantage of this approach is that it would allow banks to continue calculating effective maturity and recognise credit risk mitigation in LGDs. Additionally, with LGD floors, banks would continue to have incentives to maintain LGD models for the relevant exposures which would otherwise not apply under a pure FIRB approach anymore.
- Alternatively, or additionally, and consistently with CRR Article 179 (1)(a) above, the PRA could also require institutions to define and integrate an additional degree of conservatism into the AIRB approach.
- Finally, if the PRA had concerns about recognising credit risk mitigation in LGDs, an alternative could be to require banks to apply a simple substitution approach as already applicable under the Standardised and FIRB approaches. This way banks would remain under AIRB and continue to calculate effective maturity without having to seek additional permissions under CRR Article 162 (1).

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[3] Source: http://www.pecdc.org/index.php?page=publications