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## **EBF response to EBA consultation on Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures**

The EBF, on behalf of its member banks, welcomes the opportunity to comment on the EBA's consultation on Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures (EBA/CP/2016/21). Additionally, we thank the EBA for its interim engagement with the Industry through the Public Hearing held on the 19<sup>th</sup> of January of 2017. Our member banks found that these discussions were helpful in clarifying aspects of the intentions of the Guidelines. Notwithstanding, this meeting represented only initial feedback and this letter provides the considered response of the EBF and its members. This feedback will both reiterate and build upon the discussions at the Public Hearing. We believe that this feedback is itself more considered in consequence.

The EBF supports the objective of the draft Guidelines, to reduce unjustified variability in the IRB Approach. We understand that the EBA considers these clarifications and harmonisation necessary in order to achieve comparability of risk parameters estimated on the basis of internal models and to restore trust in these models by market participants while at the same time preserving risk sensitivity of capital requirements.

One important observation from the Public Hearing was the depth of analysis and consideration given to the draft Guidelines prior to their publication. It is clear that alternatives have been considered. It is also clear that choices have been made to develop and progress the necessary harmonisation in a considered manner. We ask, however, that consideration is provided to describing more clearly the choices afforded to banks in modelling and the role of the supervisor in evaluating or providing constraints on these choices. Already, individual supervisors are imposing the draft Guidelines as prerequisites to model and material change proposals often with strongly prescriptive interpretations that our member banks believe are contrary to those intended. Without greater detail on the context of the Guidelines, there is a significant risk that they might inadvertently promote greater divergence in modelling outcomes for similar risks. Much of our feedback, seeks to draw out this clarity within the finalised Guidelines.

We understand that the harmonisation of internal modelling practices requires a thorough analysis of current practices. Nevertheless, we would also like to draw the attention of the EBA to the aspect of cost involved. The many triggers introduced for re-development, re-estimation and re-calibration of internal models indirectly raises questions about how often this should be made and the burden to constantly recalibrate. The aspect of cost should be taken into account and eventually consider annual reviews instead of constant recalibrations. The results of the impact assessment currently underway should be carefully examined in order to factor in the cost of changes as a relevant variable. In all

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cases, the objective of MoC, of re-calibrations and of re-developments should be to ensure the adequacy of regulatory capital and not be used to require model optimisation by a supervisor. The optimality of a model should be a choice for an individual bank and here cost versus benefits will be considered.

One possibility to limit the impact on cost would be to apply the Guidelines only to future models. If this is not the case, then we would ask for adequate phase-in periods in order to avoid redeveloping a huge number of models. Some sense of proportionality should be introduced in the final version of the Guidelines or we could end up in a situation where virtually all models will need to be reworked.

As regards the timeline for implementation we would like to draw to EBA's attention the fact that many concurrent changes are being published about internal models (e.g. "RTS on IRB assessment methodology", "RTS on materiality threshold for past due exposures", "GL on the application of the definition of default", "RTS on the nature, severity and duration of economic downturn"). Somehow these Guidelines wrap up many of those changes thus there should be a comprehensive understanding of them all before implementation. The date of application from 1 January 2021 seems to be challenging.

In order to achieve reduction in the unjustified variability it is important that the guidelines are adhered to by competent authorities without imposing stricter requirements. This is, obviously, an implementation issue, but we want to highlight it for the sake of harmonisation.

In summary, the EBF supports the technically sound and well-informed approach that the EBA is following. The use of models is central to the risk management practices and it deserves an in-depth review like the one proposed in these series of EBA guidelines.

This EBF response paper addresses the specific questions raised at the end of the EBA consultative paper after some broader initial questions to consider.

## **SOME INITIAL QUESTIONS TO CONSIDER**

### On PD calibration:

- Determination of the Long-Run Average (LRA): Is paragraph 63 intended to require that the LRA is floored at the higher of the average of the most recent 5 years' default rates and the average of all available default rates? Such an interpretation may result in significantly different outcomes between identical risks held by two banks in different jurisdictions that have experienced the same economic volatility where the timing of downturns is different. If each bank has a limited series of default rates (typical) but one extends over a downturn and the other does not, the bank with the downturn in its dataset will have a materially higher LRA estimate than the other bank, notwithstanding that both banks may have suffered identical default rates over a longer time period. A more precise description of the intended application of paragraph 63 would be helpful;
- As regards the model philosophy, the EBF supports continued flexibility in modelling Point-in-Time (PIT) and Through-the-Cycle (TTC) practices; in fact, the law allows different possibilities in this respect. Banks that have a structured way of determining the rating philosophy should have the capacity to determine the most appropriate modelling choice. We understand that the EBA should strike the right balance between reducing variability and allowing certain degree of methodological freedom of choice (PiT, TTC, hybrid);

- It is important to distinguish between rating philosophy and calibration philosophy: a bank may have a PIT rating and a TTC calibration in place; the type of approach (customer versus product) deserves also consideration. Again, clarity as to what the Guidelines do not prescribe would be useful together with restrictions on bank choice, for example that model tests should be consistent with the chosen model philosophy;
- An important question, discussed at some length at the Public Hearing, is the definition of Grade or Pool and the applicability (or not) of the requirements for LRA default rate. It is not uncommon practice to determine the LRA at a portfolio level and to allocate the risk to borrowers/facilities through the calibration process. Clarity as to the level at which the LRA should be determined and expected to be verified would be helpful;
- Further detail on the relationship between the LRA of section 5.4 and the requirements of the calibration process (section 5.5.4) would be helpful. In particular, does paragraph 82 require the test of paragraph 63 to be applied to each individual grade on a prescriptive basis? This would be inconsistent with the understood freedom to choose a rating philosophy as a 5-year moving average hybrid calibration is the implied requirement;
- Explicit clarification as to the acceptability of continuous PDs and the required monitoring would be useful. Typically, continuous PDs provide for lower RWA than discrete PD calibrations. This should not in itself prohibit their use;
- For the purposes of paragraph 87(b), the concept of homogeneity is not defined so that it is unclear how granular a calibration segmentation is required. This should be a bank choice;
- The frequency of calibration should be set according to the relevance of the model and the changes made.

#### On LGD calibration:

- The underlying legal framework can vary substantially across countries; for example, average eviction periods range from 6 months to more than 5 years; the principle of “the same risk should be treated equally” can be qualified like this: “the same risk in the same legal framework should be treated equally”;
- The use of provisions as ELBE estimates is very frequent practice observed within European institutions. There are relevant reasons why banks should be able to maintain the use of provisions for ELBE that are explained in the specific responses to the EBA relevant question;
- The assumption that LGD in-default estimations have to be higher than LGD downturn seems to be not grounded on regulation as the CRR makes no mention to the need to reflect neither the downturn conditions nor the MoC in the parameter. In fact, it defines the LGD in-default as the sum of expected losses current conditions and additional unexpected losses. Arguably, the EBA Guidelines go beyond the CRR mandate;
- The use of IFRS9 introduces more variability because banks are given options on how to calculate the EL and the provisions. The relationship between IFRS9 Stage 3 and the calculation of ELBE for regulatory purposes has to be carefully considered;

- The new discounting approach proposed in the GL for the sake of harmonisation could penalise banks with longer historical series if an historical rate is used;
- Contractual interests should not have to be considered in the numerator of the loss rate computation to avoid double counting with respect to the discounting process. All the cash-in should be considered without any specific treatment for the case of unpaid late fees interests;
- We disagree with including non-representative data which introduce biases in the estimation and then apply MoC to overcome them. It would imply a double inclusion of errors within the estimation;
- The possibility to exclude non-representative data from the development sample should be allowed. NPL disposals could otherwise distort the LGD estimation. Please regard a proposed amendment to paragraph 99 of these Guidelines in the annex;
- Credit risk mitigation is an important part of the internal risk model framework and should be given proper recognition for the sake of risk sensitivity. A particular case is the recognition of exposures secured by durable goods (e.g. equipment leases and motor finance) as physical collateral for credit risk mitigation purposes because the assets on which the lending is secured exist in liquid markets with transparent and publicly available pricing and can be realised quickly;
- The concept of a closed/maximum recovery time is not meaningful in situations pertinent to a number of Member States where large numbers of NPLs exist and/or where resolution strategies are evolving. This scenario may also arise in the future elsewhere. While every effort must be made to reduce NPL levels, the recovery time concept, if misapplied, could lead to very significant but inaccurate loss estimates.

#### On Margin of Conservatism (MoC):

- It would be difficult and burdensome to classify and quantify MoC as required into the four categories. Any categorisation should not be used to mandate a minimum level of MoC in each category;
- Where modelling uncertainty is temporary, the MoC should not be required to replace data errors on a permanent basis. The IRB approval itself should serve as a guarantee that the standards are lived up to;
- Where modelling uncertainty is permanent or where, in the interests of cost/benefits or modelling simplicity, a bank chooses limited granularity within a model, an adjustment plus MoC should be recognised as permanent. This should be recognised as a natural modelling choice limited only by the Use Test;
- The framework outlined of adjustment to economic accuracy plus MoC to recognise uncertainty in this adjustment is a useful one. We understand that this framework is not yet fully elaborated in that, for example, the levels of required MoC are not specified; and that a reporting framework is also envisaged. An explanation of this position within the guidelines would be helpful in order to understand the context/intention of the proposal;
- The GL should not be taken as a minimum by supervisors. The aim of preserving the institution specific parameter setting should be made effective. If local supervisors will be able to use their own measuring yardstick, there will inevitably be unjustified variability in the outcomes;

- It would be useful for a clearer statement of expectations in regard of the adjustment and MoC individually and together. Can the adjustment be negative? MoC is, presumably, always positive. Is the aggregate of adjustment plus MoC always positive or can it be negative?
- The change in definition of default will impact many banks by increasing the number of defaults; we argue that the LGD should be reduced accordingly and the guideline should clarify that negative adjustments are acceptable. In addition, we cannot agree with paragraphs 27 and 28 that state that if an appropriate adjustment is performed, the combined effect of that adjustment and the MoC should not result in lowering PDs or LGDs. There can be situations in which the magnitude of the appropriate adjustment (if positive) could surpass the magnitude of the MoC negative effect;
- The quantification of the MoC should be done at overall level as it would be too burdensome to perform it at more granular level. Consideration should be given to the practicality of a bank, during a model development, estimating adjustments and MoC. It would be impractical to decompose adjustment plus MoC into individual components. This could require multiple versions of the model being developed, particularly where adjustments are made to respect data representativeness;
- The question is raised whether the use test would be affected; banks will have to use figures with and without MoC for the regulatory and business purposes. Banks will typically wish to use a model with the economic adjustment applied for internal purposes. It may also choose (depending upon the purpose) to use a model with MoC applied. However the degree of MoC that it would choose to use and that required to determine regulatory capital may legitimately differ;
- There could be duplication between MoC and model risk;
- As far as partial write-offs are concerned, we would kindly suggest the EBA to consider the Question ID 2014\_1064. If the bank proves to fully pursue its credit on a civil law base, then LGD estimation should be calculated by treating provisions and write offs in the same way;
- Applying the Adjustment plus MoC framework retrospectively to existing models is not practical. The framework as outlined is not common practice. This will lead to a large number of material change requests. Consideration should be given to the rollout of the framework. We suggest that it is applied only to new model approvals and material changes. Within the context of meeting the overall Guidelines by 2021, most model calibrations will have to be reconsidered. This should capture most, if not all, requirements for MoC in any case.

## ANSWERS TO SPECIFIC QUESTIONS

### **Question 4.1: Do you agree with the proposed requirement with regard to the application of appropriate adjustments and margin of conservatism? Do you have any operational concern with respect to the proposed categorization?**

We mostly agree on the application of appropriate adjustments and margin of conservatism but just in specific cases such as methodological deficiencies, estimation errors that diminished representativeness of historical observations and deficiencies due to missing data.

It can be argued that most of the deficiencies set out in the consultation paper are already being recognised in the institution-specific estimations and the appropriate adjustments are applied. Therefore, we wonder whether it is necessary to quantify MoC by applying an 'unbiased' adjustment and a conservative one. In addition, there could be a potential overlapping effect of applying several conservative adjustments. This needs to be assessed carefully and adjusted for in the application of capital requirements.

In the definition and quantification of MoC and related adjustments the Regulator should request banks to focus only on the most relevant and material ones. A wider application and definition of the MoC will not lead to less variability in RWA. It is the modelling practices and banks underlying exposure data that results in the differences in RWA. This will also be the situation after the introduction of the MoC. The MoC will only ensure that it is implemented by all banks. A common disclosure practice is just an important tool that must be developed further to secure comparability.

Further standardisation of the criteria for the adjustments and MoC identification and quantification is welcomed and would avoid or reduce an unjustified RWA variability between banks.

Furthermore, the proposed C category seems more relevant in the monitoring process; in model development, the identified errors will be limited to categories A and/or B. Category C seems related to underperformance or optimisation of models not to methodological deficiencies.

We oppose that changes in business processes, the economic or legal environment should be subject to a quantification of a MoC. It would not be possible to quantify such an external factor. This should rather relate to an operational risk issue. Such a MoC factor seems as a new capital requirement, as banks are constantly subject to regulatory changes and capital and liquidity reforms as well as changes in the economic environment. In addition, changes in the underwriting standards or in the recovery standards should not be subject to MoC if the bank can prove that parts of the historical data set create representative problems between the current portfolio and the RDS, and consequently should be disregarded. Instead, if banks are obliged to apply a MoC over a non-representative RDS this will duplicate the complexity and opacity of the information and risk drivers used to estimate the risk parameters. As such, we do not agree with paragraph 41 which limits substantially the number of exclusions that can be performed when setting the reference data set for the default rate calculation and with paragraph 25, which states that institutions should apply a MoC if there are changes in relevant processes.

We cannot agree with the proposal to evaluate the impact of each MoC in terms of final risk parameters: this approach implies the estimation of a number of  $n$  models for each MoC applied which impact may not be linear. Drawing comparisons between the model with all MoCs versus the model ex-MoCs could be more accurate to assess the overall adjustment impact.

As regards missing data, we believe that only not informative missing (i.e. due to lack of information) should be included in this category. On the contrary, informative missing (i.e. those having an economical underlying meaning) should be treated differently without the application of any MoC.

Finally, there is need to clarify the non-linearity of MoC and the consequent need to aggregate them in such a way to take into account the implicit correlation (i.e. not summing them up).

**Question 5.1: Do you see any operational limitations with respect to the monitoring requirement proposed in paragraph 53?**

No. In general, one-year default rates are already being calculated at least on a quarterly basis. No further operational limitations should be present. It can be argued that quarterly calculation for Low Default Portfolios (LDPs) will provide little of information value considering the very low amount of defaults that will be observable within that time frame. Rather than operational limitations, we believe that the new monitoring requirements will have an impact in terms of additional effort.

EBA should clarify if paragraph 39, namely the requirement to review the rating assignment no later than 3 months, is only related with one-year default rates calculation or it also includes the revision of the rating grade. If the latter is included in the scope of paragraph 39, we cannot agree as the rating models could have a qualitative component (especially for Corporates) that cannot be reviewed in such a short period.

**Question 5.2: Do you agree with the proposed policy for calculating observed average default rates? How do you treat short term contracts in this regard?**

We largely agree with the proposed policy. The overlapping windows policy is the widely used manner of calculation of the observed average default rates. The representativeness of the defaults occurring at the beginning and at the end of the observation period is considered negligible, so relevant biases are therefore considered not possible taken into account that internal data will cover at least 5 years.

Regarding the bias due to the choice of fixed reference dates in case of Non Overlapping method, the volatility could be considered acceptable if a full economic cycle is included in the long run average so that changing the observation point substantially doesn't move the final average value, while considering a limited period in the cycle can influence the value if a downturn/upturn period is considered.

**Question 5.3: Are the requirements on determining the relevant historical observation periods sufficiently clear? Which adjustments (downward or upward), and due to which reasons, are currently applied to the average of observed default rates in order to estimate the long-run average default rate? If possible, please order those adjustments by materiality in terms of RWA.**

In our opinion the guidelines should further clarify these important topics for the comparability of the rating models. In particular, we would like to know if it is not strictly necessary to consider a whole economic cycle.

Potential adjustments could be:

- If the internal series of one-year default rates (DR) is not large enough to encompass a whole economic cycle, it is extended using generally an external series of default rates which presents a high correlation with the internal one (the external series may be historical or simulated with MoC);
- The long-run average default rate is calculated as the average of the extended DR series.

We question if the competent authorities will still be able to set a national requirement on what is considered to be a downturn period.

A similar approach could be also used in order to manage change in the legal environment, in particular in the definition of default, over the “relevant historical observation period”.

**Question 5.4: How do you take economic conditions into account in the design of your rating systems, in particular in terms of:**

- a. definition of risk drivers,
- b. definition of the number of grades
- c. definition of the long-run average of default rates?

It is important that risk drivers are based on achieving the best possible estimate of obligor default risk, and not to capture economic conditions as such unless they are deemed to be significant contributors to the default risk of the obligor.

**Question 5.5: Do you have processes in place to monitor the rating philosophy over time? If yes, please describe them.**

Supervisory standards may differ across various points:

- Yearly update of estimates;
- Monitoring of the rating philosophy (*Point In Time vs Through The Cycle*) will vary based on the exposure categories in question e.g. retail vs corporate;
- Migration matrix analysis to verify rating stability.

**Question 5.6: Do you have different rating philosophy approaches to different types of exposures? If yes, please describe them.**

The stocktaking of the EBF study on IRB models for residential mortgage portfolios gives indications.

**Question 5.7: Would you expect that benchmarks for number of pools and grades and maximum PD levels (e.g. for exposures that are not sensitive to the economic cycle) could reduce unjustified variability?**

No. The number of pools and grades should reflect the ability of entities to discriminate risk. The limitations should rather be linked to individual banks structure of eligible exposure classes, collateral types, industries and products. These could be specified in the Guidelines.

We should not forget that a standardised Pillar 2 disclosure template is sufficient for comparative purposes.

**Question 6.1: Do you agree with the proposed principles for the assessment of the representativeness of data?**

Generally, yes. But the mandatory use of the whole population of defaults does not have a statistical justification.

In some cases it is expected that the distribution of some risk drivers change over time, so differences will appear when compared with their distribution in the current portfolio. It is not clear which criteria should be followed in order to adequately assess these situations.

As regards LGD models the development team should always consider the significance of the risk drivers used to differentiate loss rates estimates not only in the sample but also in the real portfolio since long historical series can include biases in this sense.

On the other hand a more complex topic concerns the inclusion of all the defaults in the sample: this principle can be potentially in contrast with the idea to have historical series as broad as possible (indicated by both CRR and EBA), in fact the consequence of a broad historical series can be the impossibility to have a complete information for all the defaults recorded and therefore the need to exclude some cases (for example because it is not possible to calculate correctly the target variable or they have a different default definition). For example the current process of the sample definition in LGD models foresees the exclusions of some defaults for data quality reasons: if all the defaults need to be included in the final sample, for these cases a LGD will be forcedly assigned. The question is therefore which LGD should be assigned and homogenous rules have to be provided in order not to create variability. Moreover not only data quality exclusions are performed: for example some defaults are excluded since they are open and their recovery process in progress (they are not considered irrecoverable such as Incomplete Workout cases): for these situations, detailed also hereinafter in the GL, a clear guidance of the recovery rate estimates has to be provided in order not create undue variability among banks.

In long historical data series older data could be assigned a lower weight if it is less representative than the recent data. Flexibility should be allowed provided that any difference in the weighting is properly documented. Not allowing such flexibility would lead to imposing biases in the LGD which then afterwards should be corrected by a MoC which would not be intuitive.

With reference to the treatment of an exposure that after the return to non-defaulted status is classified as defaulted again proposed by the art 90, we think it is not specified what happens for all cases of exposures "returned to non-default status" for which a 12-month observation period after re-classification is not observable. Additionally, it is not clear how this treatment should be combined with the probation period which the RTS on default definition introduced and requested to implement by 2021.

In particular, assuming to implement a 3-month probation period, the exposures returned to non-defaulted status, will continue to be classified as default for the following 3 months, prior to be properly considered non-default. In case of subsequent re-default after non-default classification, based on the proposed treatment, the 3 months of "imposed" default status deriving from the probation period would not be taken into account to define the number of months occurring between re-default and non-default classification.

See example provided below for further clarification:

Month	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar
Status	D	P	P	P	P	P	P	P	P	P	P	P	P	D	D
3months prob.	D	D	D	D	P	P	P	P	P	P	P	P	P	D	D
Art. 90 no prob.	D	P	P	P	P	P	P	P	P	P	P	P	P	D	D
Art. 90 with prob.	D	D	D	D	D	D	D	D	D	D	D	D	D	D	D

D= default

P= performing

It is important to highlight that the proposed threshold (1 year) is too conservative; internal data should be used in order to find the most reasonable threshold, after the introduction of a probation period (minimum length of 3 months) as indicated in EBA Guidelines on the application of the definition of default under Article 178 of Regulation (EU) 575/2013.

**Question 6.2: Do you agree with the proposed treatment of additional drawings after default and interest and fees capitalized after the moment of default in the calculation of realized LGDs?**

As far as Retail exposures are concerned, we agree with the proposed treatment of additional drawings for both CCF and LGD and banks' models are already developed aligned with CRR and EBA GL.

The difference between unpaid late fees, interest and fees needs further clarification. An example on different type of flows to be considered and corresponding treatment would be extremely helpful. The same goes with fees and cost terms. For what concern costs, all direct costs and relevant indirect costs are considered in the economic loss and for LGD calculation purposes. Fee can be a misleading concept in the consultation document: sometimes it can be assimilated to interest and sometimes to cost, also considering that there is no clear taxonomy.

It seems that the Guidelines give way to confusion between accounting schemes and the concept of economic loss, in particular for the issue concerning contractual interests. All the fees are considered in the economic loss as well as all the other direct costs: they are included as well in the exposure at the denominator of the LGD until the beginning of the default event (or the beginning of the litigation phase in case of multi-stages model), while they are not added to the exposure if they are recorded after the default event (or litigation event) but, as stated above, considered as cash-out. On the other side the interests can be further divided in two categories:

- Contractual interests (interests accrued on capital based on terms and conditions contractually agreed with the client): these interests are included in the exposure at the denominator of the LGD until the beginning of the default event (or the beginning of the litigation phase in case of multi-stages model) but have not to be considered in the numerator of loss rate computation since their inclusion would result in a double counting with the respect to the discounting process (whose section is separately treated in the GL). Moreover the inclusion of these interests such as costs in the numerator would represent an accounting scheme which is a completely different matter compared to the economic loss: the share of interests which will be cashed-in will be adequately discounted to take into account the time

value of money but nothing more has to be added in the LGD formula. The confusion between accounting scheme and economic loss should be corrected.

- Unpaid late fees interests (interests accrued on unpaid capital): these interests are included in the exposure at the denominator of the loss rate until the entry in default status (or until the entry into the litigation phase if a multi-stages model is applied), but the GL ask to consider that in case of recovery of late interest that have not been previously capitalized the moment of recovery should be considered a moment of capitalization. If this requisite impose not to consider the cash-in related to unpaid late fees interests and exceeding the amount included in the EAD for the loss rate computation, the proposal is not correct: in fact a cash-in is always a cash-in and the priority rules for the cash-in repartition decided by the bank (capital, interests, etc.) should not distort the economic loss estimation. All the cash-in should be considered without any specific treatment for the case of unpaid late fees interests.

Regarding the representativeness of data, we agree on the importance of representativeness of the development sample to a more recent portfolio, but with the exceptions highlighted in the proposed amendment to paragraph 99 (see annex).

Within the new GL an inconsistency is detected, between the points 99/110 and point 111 (exactly like it happens in CRR art 181.1(a) and 179.1(d)), since the former asks for representativeness of the development sample towards the application, while the latter asks for the inclusion of all defaults, specifying that "it is not possible to remove the observations that are not fully representative from the estimation sample. However, in this case institutions should apply adequate margin of conservatism to account for the weaknesses in data and, if possible, adjust the data to ensure greater representativeness".

We disagree with the requirement to include non representative data which introduce biases in the estimation and then apply MoC to overcome them. Indeed, it would imply a double inclusion of errors within the estimation. Therefore, we deem that the possibility to exclude non representative data from the development sample should be allowed (see annex 1). The same concept should be applied not only to not representative data but to data with quality issues as well.

Given the fact that data used for the purpose of LGD estimation has to be sufficiently representative to the current portfolio covered by the relevant LGD model, it is not clear how this is not included within the periodical review of internal models.

Moreover, with regards to the point 103(a), we deem that the comparison between the reference data set (composed by defaulted exposure, over various points in time) to the current portfolio of non-defaulted exposures would lead to undesirable results, since the two analysed samples are physiologically different in terms of characteristics of the relevant risk drivers. In our view it should be clarified how to handle situations, like this one, when lack of representativeness (i.e. distributions of risk drivers are different) is solely due to intrinsic differences between defaulted and performing exposures.

**Question 6.3: Do you agree with the proposed specification of discounting rate? Do you agree with the proposed level of the add-on over risk-free rate? Do you think that the value of the add-on could be differentiated by predefined categories? If so, which categories would you suggest?**

There is division of opinions as to whether the use of a historical risk-free rate should be used to estimate loss rates. The advantage of this choice is to reduce the divergence between discounting effect for LGD computation and contractual interests with the related recoveries which could cause negative LGDs. The disadvantage is that it can be inappropriate to discount the cash flows with this approach since a forward-looking perspective has to be taken into account as underlined also by the BCBS which indicated current rates approach as the most suitable since *"their use allows the consideration of all available information and facilitates the comparison between LGD estimates from different portfolios"* (Working Paper 14<sup>1</sup>).

We agree with the idea of determining the final rate as the sum of a risk-free component plus a credit spread but in more details:

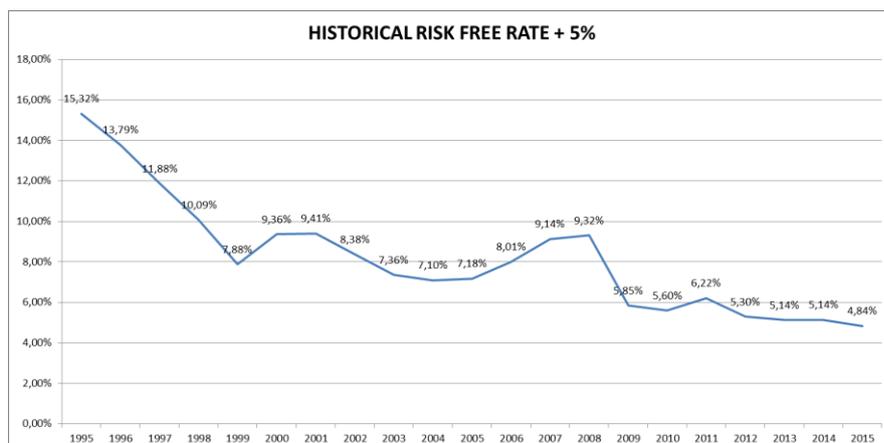
Risk-free rate: the usage of an historical rate would unduly penalise the banks having historical series as broad as possible as requested by both CRR IV and EBA: in fact years before the introduction of the Euro were characterized by high volatility of the risk free rates which would be reflected in the results. The natural consequence would be the elimination of the oldest data from the database with a clear reduction of the available information, which is not the goal of the GL. Moreover the GL asks for a primary interbank offered rate equal to the 1-year EURIBOR or a comparable interest rate in a currency of the exposure: this measure is not representative of the risk free component which is typically more linked to a one-month or maximum three months EURIBOR. Finally before 1999 EURIBOR did not exist and therefore a proxy should be derived;

- Spread component: the 5% spread for all the segments and products is not suitable because it does not consider the peculiarities of each segment and product types and is indeed too high if compared with the current commercial spreads applied in the majority of the segments (only Retail exposures show higher values with the exclusion of Mortgage product type). For the spread component it is fundamental to consider these peculiarities together with the different portfolio and commercial characteristics of each bank: the results would therefore create variability among banks but this variability may be justified. Our proposal is therefore to reflect current spreads of the bank by segment and product type and to define an average on the most recent years in order to reduce volatility. The add-on does not fluctuate with the level of the primary interbank offered rate, it is always set to 5%.
- Regarding categories for the add-on we think it would be appropriate to consider that different types of collateral can carry different add-on rates depending on the risk level of the collateral.

The following graph illustrates a simulation of the implementation of the GL requirement with a risk free determined according to a one-month EURIBOR (LIBOR before 1999) and the 5% spread:

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<sup>1</sup> Refer to: *Studies on the Validation of the Internal Rating Systems*, Basel Committee on Banking Supervision, Working Paper No. 14 February 2005.



It is clear that these rates would be not sustainable and include a lot of variability in particular in the first year of the historical series. The historical risk free rate is too much volatile, the same nominal losses would be evaluated with a different LGD only because the default started in a different year; therefore in the development sample some LGD would be over-weighted and others under-weighted in a random way.

**Question 6.4: Do you agree with the proposed approach with regard to the specification of historical observation period for LGD estimation?**

Yes. It is the easiest option and difficult adjustments are avoided. However it should be jointly evaluated with the other requests of this GL (i.e. adjustment for different default definition, discount rates, inclusion of all defaults in the development sample) for the sake of consistency.

**Question 6.5: Do you agree with the proposed treatment of incomplete recovery processes in obtaining the long-run average LGD?**

We largely agree with the proposed approach, but it is important to clarify that institutions could use multiple approaches to include incomplete recovery processes within the estimates. Important exceptions are:

- Incomplete recovery process should be considered to the extent reasonable projections can be made (considering at least a 12-month observed period in line with consideration of cures).
- When collateral is available (and subject to enforceability conditions), LGDs should reflect recoveries coming from repossession.

The overall proposal relies on the strong assumption that closed processes are fully representative of incomplete ones but this may not be taken for granted; in fact, the consultative paper recognizes the weaknesses embedded in the proposal.

An unclear question is how missing information must be estimated. This could lead to a wide margin of discretion due to methodological choices. The specific proposal seems to

increase the complexity that is required for the estimation of the long run LGD – with an increase in model risk and consequently the need for more conservatism, while it is not clear how this would compensate for more comparable results among institutions.

**Question 6.6: Do you agree with the proposed principles on the treatment of collaterals in the LGD estimation?**

We do not agree with the proposal to consider the valuation of the collateral before the entry into default: such value has to be taken into account at the default event coherently with loss. Moreover we think that an appropriate Downturn model can already include the potential decreases in collateral value from the point of LGD estimation to the eventual recovery, in particular those resulting from the changes in the market conditions, state and age of the collateral and, where relevant, currency fluctuations. Therefore we think that this issue should be properly treated in that component of LGD modelling (and in the GL about to be published) without adding further elements of variability in interpreting and including this phenomenon in the treatment of collateral.

Other issues deserving attention are:

- Recovery cash flows from collaterals not recognised by CRR should be taken into account somewhere; agreement should be reached on this allocation (should it be on the 'prudentially' unsecured portion?);
- Recognising the sources of the cash flows and allocating them adequately to the specific collateral or unfunded credit protection has operational challenges (collaterals may cover several exposures, operational difficulties in cases of disposals, etc.);
- LGD approaches should not unnecessarily separate the treatment of collateralised vs unsecured exposures as the recovery process is often managed at borrower level.

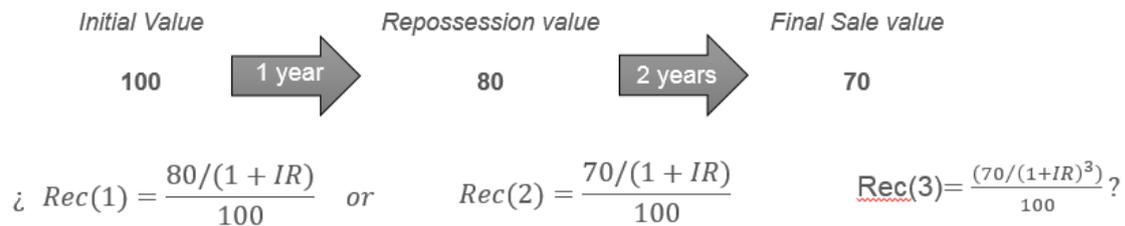
**Question 6.7: Do you agree with the proposed treatment of repossessions of collaterals? Do you think that the value of recovery should be updated in the RDS after the final sale of the repossessed collateral?**

Yes, we agree with the proposed treatment (repossession treated as a recovery, not necessary to wait until the sale of the asset). In this regard, sales prices could be included to the extent that they help establish adequate haircuts on repossessed valuations.

However the value of the final sale should be updated in the LGD RDS for future update of LGD estimative. This means that if there is not yet a sale, an adequate haircut should be applied. However, if the sale is realized before the next LGD revision, then it should be recognized in the LGD RDS at the moment of the sale.

Comparisons against sale prices may indicate additional factors apart from credit risk (example: reputational issues).

Below we include an example of the different approaches:



**Question 6.8 : Do you think that additional guidance is necessary with regard to specification of the downturn adjustment? If yes, what would be your proposed approach?**

Downturn topic is very relevant and is indeed a source of strong variability among banks. We think that additional guidance is necessary in order to harmonise the approaches whose impact is very strong not only on Performing LGD side but also on Defaulted Assets for the RWA computation (since many banks use this element as the differentiating one between ELBE and LGD in-default).

The guidance should consider approaches based on macroeconomic indicators and should indicate how to relate them with the loss rates (for example through simulative approaches) and how to consider idiosyncratic factors of the loss rates which does not depend on the economic cycle but strongly influence the loss rates observed (i.e. credit sales). A range of potential approaches should be indicated as well as the proper definition of Downturn conditions and the downturn period. If minimum or maximum impacts of the Downturn factor are expected they should be clearly explained in this Guideline.

**Question 7.1: Do you agree with the proposed approach to the ELBE and LGD in-default specification? Do you have any operational concerns with respect to these requirements? Do you think there are any further specificities of ELBE and LGD in-default that are not covered in this chapter?**

We agree that, as already specified in Article 54(2)(c) of the RTS on IRB assessment methodology, the direct estimation of LGD in-default should be consistent with the methodology set for LGD for non-defaulted exposures in order to avoid potential cliff effects. The main topics concerning ELBE and LGD in-default are aligned to EBA RTS.

There are relevant reasons why banks should be able to maintain the use of provisions for ELBE including:

- There is little or no material reduction in RWA variance;
- Provisioning models are subject to auditor scrutiny and public disclosure and therefore can be understood as a common metric;
- The proportion of defaulted exposures to overall performing exposures will generally be quite small; it is unusual for large volumes of NPLs to exist on a bank's balance sheet and where this does exist, this should be considered as an exceptional problem;

- It should be noted that the overall quantum of regulatory capital required is not affected by ELBE: it merely allocates between EL and UL. RWA on defaulted assets should be replaced by Global Charge (GC) for comparison purposes;
- The conditions under which firms are able to use provisions should be widened so that development of new ELBE or redevelopment of existing IFRS9 models is not required;
- Requiring either the build of a new ELBE/BEEL model, or calibration of existing LGD models for ELBE/BEEL, is yet another piece of work to add to the pipeline of activities that firms will need to undertake in the short to medium-term;
- The current book of work for credit risk modelling is very full including changes stemming not only from the EBA but also IFRS9 and potential future changes that will be introduced via the new Basel package.

The main topics still to be clarified are:

- since the defaulted assets LGD for regulatory capital purposes is strictly related with the Stage 3 LGD on IFRS9, the coherence between the approaches should be considered, for example IFRS9 requires to have a nominal LGD which is discounted with the effective interest rate directly on the application portfolio. Therefore it is proposed in this case to adopt proper corrections with respect to the standard approach used for the Performing LGD estimation in order to estimate a nominal LGD to be shared between managerial and regulatory purposes and to ex-post discount it only for the latter as requested by the Regulation (through the discounting rates and an average time of recovery);
- the treatment of the open facilities has to be clearly documented also in relation to Question 6.5 for Performing LGD, it seems that the requisites here indicated are different from the section of the open facilities for Performing LGD estimation (refer to question 7.3);
- the difference between ELBE and LGD in-default is currently determined by the majority of the banks through the Downturn factor. Nevertheless the GL asks to assign all the other MoC to the LGD in-default and not to ELBE: which MoC are included in this specification? The GL should better define the components differentiating the two LGDs (ELBE and LGD in-default) since their difference determines RWA on defaulted facilities.

**Question 7.2: Do you agree with the proposed reference date definition? Do you currently use the reference date approach in your ELBE and LGD in-default estimation?**

Banks at large agree with the proposed reference date definition for the defaulted assets LGD. But banks that currently have not used reference date in their modelling of ELBE and LGD in default will need to re-develop their approach which will be a significant change.

It has to be remarked that the definition of the reference date depends also on the definition of default.

**Question 7.3: Do you agree with the proposed approach with regard to the treatment of incomplete recovery processes for the purpose of estimating LGD in-default and ELBE?**

We think that the treatment of the open facilities has to be clearly documented also in relation to Question 6.5 for Performing LGD and it should be consistent. The inclusion of open defaults can heavily distort the estimates depending on the logic adopted for the modelling technique of defaulted assets (see example in the previous question 7.2). In one bank's model for example, going forward on the timeline, the open positions would assume an increasing weight over the total sample and therefore would strongly influence the results. The indications of the GL are not totally clear to us: *"The only exception envisaged in paragraph 169 with respect to the inclusion of incomplete recovery processes in the ELBE and long run average LGD for defaulted exposures is that those can be included only with respect to reference dates beyond which factual recovery and costs have been already observed. This was put in place to avoid a circular reference of an estimation within the estimation. The estimation of the future costs and recoveries on incomplete recovery processes should be consistent between defaulted and non-defaulted exposures and should be based, as suggested in paragraph 138(c), on a comparison of the costs and recoveries realised on these exposures until the moment of estimation to the average costs and recoveries realised during similar period of time on similar exposures. For this purpose institutions should analyse the recovery patterns observed on both closed and incomplete recovery processes taking into account only observed costs and recoveries"*.

What does the term *beyond* mean in this paragraph? Is it possible to provide an example about that? Which differences are expected with the analogous treatment for the Performing LGD estimation? We think that here there is a strong link between the approach proposed and the modelling technique: the two sides cannot be considered separately and a strong attention has to be put on this topic.

Our opinion is that:

1. In principle, only closed recovery processes should be considered for the ELBE and LGD in-default estimation for the sake of simplicity;
2. Incomplete recovery process should be considered to the extent reasonable projections can be made (considering at least a 12-month observed period in line with consideration of cures).
3. When collateral is available (and subject to enforceability conditions), LGDs should reflect recoveries coming from repossession.

#### **Question 7.4: Which approach do you use to reflect current economic circumstances for ELBE estimation purposes?**

Feedback received from banks indicate that most of them reflect current economic circumstances for ELBE estimation purposes through the risk drivers and LGDs are, in general, calibrated according to observed recoveries experienced under current economic circumstances.

We think that a further adjustment to the ELBE in order to consider the current economic circumstances could be arbitrary and could unduly increase the variability instead of reducing it. It is not clear why the Downturn component is linked to the ELBE estimation if this component should only be added for the LGD in-default.

This topic is related with the possibility to use provisions as the best proxy for expected loss and with the IFRS9 prescriptions: can banks harmonise the methodology for the LGD macroeconomic conditioning in IFRS9 with the request to have an ELBE reflecting current economic conditions? A coherence treatment with the provisions on NPL has to be taken

into account because the Excess Reserve / Shortfall depends on this comparison and EBA should carefully evaluate all the implications.

In our opinion the inclusion of the MoC in the LGD in-default and its non-inclusion in the ELBE will increase artificially the RWA for defaulted exposures. We do not see any argument that supports such a differentiated treatment between both metrics.

In addition, we consider that the inclusion of a downturn conditions component is a gold plating of the rules prescribed in the CRR as article 181(1)(h) only refers to additional unexpected losses during the recovery period.

**Question 7.5: Do you currently use specific credit risk adjustments as ELBE estimate or as a possible reason for overriding the ELBE estimates? If so how?**

Feedback received from banks indicates that practices vary among banks.

However, we consider that this proposal is correct, in particular for big exposures subject to renegotiation or restructuring measures and in some cases for low default portfolios. Therefore we think that in these limited cases an override of the ELBE with evaluation performed by the position manager (specific credit risk adjustment) would be justified and would avoid creating an unjustified Excess Reserve or Shortfall. We agree that for these cases adequate documentation should be provided to support the process and the decisions.

In this sense we ask for a better clarification of the demonstrations required to support the override / substitution of the ELBE. In our opinion it is not feasible to demonstrate the appropriateness of the specific credit risk adjustment through both the economic loss and a re-computation via the historical risk free rate plus a 500 bps spread.

The question whether the ELBE can directly be derived from the provisions should be clarified. Moreover an override of the ELBE with evaluation performed by the position manager (specific credit risk adjustment) could be justified where the statistical model is not able to factor in the peculiarities of a client / position (for example because of particular renegotiation measures, i.e. forbearance measures) and would avoid to create an unjustified Excess Reserve or Shortfall. We agree that for these cases adequate documentation should be provided to support the process and the decisions.

**Question 8.1: Do you see operational issues with respect to the proposed requirements for additional conservatism in the application of risk parameter estimates?**

The vast list of topics where MoC could lead to operational complexity. Regulators should restrict the scope of MoC to a limited and well defined set of weaknesses.

It is necessary that the Regulation better clarifies (with some examples) the cases of “deficiencies related to implementation or application of risk parameters”, focusing only on the most relevant and material.

**Question 9.1: Do you agree with the proposed principles for the annual review of risk parameters?**

In general, banks have annual review procedures in place in line with the principles proposed in these Guidelines.

Clarification would be welcomed on the concepts of re-development, re-estimation and re-calibration (in particular for LGD), as well as what exactly the EBA expects as to the frequency of the monitoring: quarterly or yearly?

**Question 10.1: Do you agree with the clarifications proposed in the guidelines with regard to the calculation of IRB shortfall or excess?**

We do not agree with this proposal.

This should be carefully evaluated together with IFRS9 implementation; BCBS already understood the implications and in fact in the "Regulatory treatment of accounting provisions – interim approach and transitional arrangements" it is clearly written that:

*Total eligible provisions*

*The Basel II framework defines "total eligible provisions" under the IRB approaches as the sum of all provisions (eg specific provisions, partial write-offs, portfolio-specific general provisions such as country risk provisions or general provisions) that are attributed to exposures treated under the IRB approaches (Basel II paragraphs 380-383). In addition, total eligible provisions may include any discounts on defaulted assets. Specific provisions set aside against equity and securitisation exposures must not be included in total eligible provisions.*

*CET 1 deduction and Tier 2 add-back*

*Under the IRB approaches, banks compare the total eligible provisions to the regulatory measure of EL calculated by banks as probability of default (PD) times loss given default (LGD) times exposure at default (EAD). Any shortfall between total eligible provisions and regulatory EL is fully deducted, without considering tax effects, from CET1 capital (Basel III paragraph 73); whereas any excess is added to Tier 2 capital, up to a limit of 0.6% of credit RWAs calculated under the IRB approaches (Basel III paragraph 61).*

*Exposure at default*

*Under the IRB approach, all exposures are measured gross of specific provisions and partial write-offs (Basel II paragraph 308). Thus, neither specific provisions nor general provisions are deducted from EAD.*

We think that EBA should align its proposal to BCBS; in fact the Shortfall computation would be strongly influenced by this approach as highlighted in the following example:

Time T0	Exposure	Provision	Write-Off	Estimated LGD	ELBE	Excess/Shortfall	
Initial situation	T0	100	30	0	30%	30	0
Time T1	Exposure	Provision	Write-Off	Estimated LGD	ELBE	Excess/Shortfall	
30 € Write-off	T1	70	0	30	30%	21	-21
Time T1 new	Exposure + Write-Off	Provision + Write-Off	Estimated LGD	ELBE	Excess/Shortfall		
Write-off correction	T1 new	100	30	30%	30	0	

Our opinion is that it is not correct to bear a shortfall that overlaps with the loss on the Financial Statement. Such a treatment is not fundamentally correct.

**Question 11.1: How material would be in your view the impact of the proposed guidelines on your rating systems? How many of your models do you expect to require material changes that will have to be approved by the competent authority?**

This question should be assessed in the light of the quantitative impact study that the EBA is currently conducting. However, it is expected that due to the guideline the majority of the models need to be significantly changed and approval is required from the competent authorities. Nevertheless, some indications are the following:

- The LGD in-default guidelines would for the majority of the banks have a material impact;
- ELBE could be potentially material in many banks especially if the indirect approach is used;
- In terms of PD and LGD, the methodological impact is limited but the operational cost of enhancements to documentation, justifications and changes to processes is significant and those changes are likely to also require competent authority approval.

## Annex

### Proposed changes to paragraph 99

Original text	Proposed amendment
<p>99. Institutions should perform an appropriate analysis to ensure that the data used for the purpose of LGD estimation is sufficiently representative to the current portfolio covered by the relevant LGD model. Such analysis should be performed separately for internal and external data as well as for data from different sources.</p>	<p>99. Institutions should perform an appropriate analysis to ensure that the data used for the purpose of LGD estimation is sufficiently representative to the current portfolio covered by the relevant LGD model. Such analysis should be performed separately for internal and external data as well as for data from different sources.</p> <p><u>In order to avoid any unintended distortion, a specific modelling should be performed on data for LGD estimation regarding non-conventional recovery processes disposed by Institutions as well as cases of merger and acquisitions authorised by Competent Authority.</u></p>

The proposed text tries to bridge the two principles of i) completeness of the information used and ii) its representativeness by way of the introduction of a specific modelling of data. The proposed solution needs to be introduced at least for some peculiar situations given that a full sterilisation of non-representative information requires changes in the CRR, which remain our first option that we will represent in the context of CRR revision that is underway