EBA Consultation Papers on the Draft Guidelines on Stressed Value at Risk (CP48) and on the Draft Guidelines on the Incremental Default and Migration Risk Charge (ICR) (CP49)

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Ladies and Gentlemen,

On 30 November 2011, EBA published "Guidelines on Stressed Value at Risk" (CP48) and "Guidelines on the Incremental Default and Migration Risk Charge (IRC)" (CP49). We welcome this opportunity to comment on this Papers.

First, the subsequent paragraphs will describe the common themes affecting both consultation papers. This will be followed by a more detailed discussion of the respective documents.

General Comments

The current CRD III requirements came into effect on 31 December 2011. By way of preparation, banks developed their models for the stressed VaR and the IRC. Presently, these models have already completed the roll-out and approval process. The presently proposed EBA Guidelines seek to specify the rules in greater detail. Yet, they can no longer serve such an objective because they were issued too late. In view of the fact that – particularly during IRC modelling – there is no single best practice solution, it would appear to be more constructive to compile a list of the existing "range of practice" instead of curtailing its diversity. This is particularly true in view of the fact that, in general, the statutory requirements concerning banks are sufficient. Furthermore, the proposed amendments may, at best, yield a marginal improvement in terms of model quality.

Although the draft guidelines are largely in line with the requirements promulgated by the Basel Committee in the past, there are various instances where the guidelines turn out to be more stringent than the current approach. This is due to the fact that, occasionally, the new proposals tend to be more explicit and list minor derogations which, up to now, had been treated as optional. Implementing some of these proposals on a mandatory basis will be difficult and is going to tie up considerable resources. In addition to this, the models would have to be revised yet again. To our preliminary understanding, their implementation is due as early as 2012, i. e. within one year after the model's first-time-adoption. In view of the need for continuity, such a swift amendment of the provisions would prove utterly counterproductive. Hence, we feel that such an approach would be inappropriate. We therefore recommend that, for the time being, pre-existing models which have already been rolled out and approved should be allowed to pass the litmus test of practical application, first.

Prior to their final implementation into national law, any assessment of the extent and content of the changes that will become necessary would be premature and thus unrealistic. This notwithstanding, as of that point in time, they, too, should already be covered by the audit scope. Hence, the German

banking industry is strongly advocating in favour of an appropriate transition period beyond the year 2012 that will grant banks enough time for implementation of the provisions. Otherwise, the resulting workload would no longer be feasible.

Incorporating these new requirements into a pre-existing model ties up further resources. However, in view of the Basel III implementation (e. g. model approach for the CVA charge) these resources are already largely exhausted. Hence, we should like to propose synchronising the timeline with the implementation of the CRD IV provisions. This is due to the fact that upon their 2013 implementation deadline, the systems will be due for an overall review, anyway.

We should like to assume that the proposals contained in the two consultation papers do not collide with the Basel Committee's "Interpretive issues with respect to the revisions to the market risk framework" dated November 2011 and we would like to ask for a corresponding review along with the respective corrections thereof, if and when needed (cf. e. g. CP49 Paragraph 7, Section 3).

Furthermore, in terms of the market risk models, we would like to point out that within the "Fundamental review of trading activities", the Basel Committee will probably perform a profound realignment. At present, it is absolutely possible that the model adjustments initiated by the EBA guidelines may become redundant or could even collide with the fundamental Review.

Specific comments on CP48

Paragraph 4 and 5

Under the present proposal, the identification of the twelve month stressed period needs to take place separately for each legal entity for which also a VaR is reported. From the point of view of a cross-border bank, the process for selection of the stressed period is problematic. This is due to the fact that this process has to be reiterated for many legal entities. These banking groups should be allowed to apply to the respective subordinate levels the same stressed period that was chosen at group level. We propose a clarification to the effect that the group level shall be sufficient at this juncture.

Section 2 reads as follows: "On the other hand, if a supervisor permits different legal entities positions all to feed into a single internal VaR model at a consolidated level, then the stressed period may be defined based on the entire group's trading book positions." This wording is too vague: There is no explicit authorisation to use the stressed period selected at a consolidated level also for

local reporting purposes at the level of the respective national subsidiary. We propose an amendment to that effect.

Paragraph 6, Section 7
The second part of the first sentence prohibits weighting of historical data during the stressed period. In our view such an exclusion is pointless. In practice, weightings could be calibrated in a way that ensures that a predetermined weight shall simultaneously correspond to a predetermined period. To this end, more recent time series could be given a higher weighting than periods dating back to the more distant past. Since the general exclusion of weightings imposes an unnecessary restriction upon the methodology, we would like to suggest deleting the respective part of the sentence.

Paragraph 6, Section 8
When it comes to the calibration of the stressed VaR model, this section stipulates that it shall be permissible to use the so-called “antithetic data”. Yet, the method for determining such data is left unclear. The same applies to the potential compatibility of this provision with the other requirements concerning the stressed VaR.

Paragraph 7, Section 1 and 2
Under the provisions of Paragraph 6, Section 3 that historic period shall be selected which produces the highest VaR measure. Pursuant to Paragraph 7, Section 1, “statistical assessments” have to be produced as part of the justification for the respective stressed period chosen. In this context, once the period with the highest VaR measure has been selected, it remains unclear which “statistical assessments” would still be necessary. In our view this requirement would become redundant. We therefore propose deleting the second sentence.

Particularly in view of the standardised selection of the market data period across portfolios and asset categories, consideration of stressed periods prior to 2008 (Paragraph 7, Section 2) would be problematic in terms of availability and market data quality. Therefore, generally speaking and in terms of prudential supervision, as a basis for identification of the stressed period, a post-2008 history should be deemed sufficient. We propose a corresponding clarification to that effect.

Paragraph 8, Section 3
Basically, the request that any changes to the choice of the selected stressed period shall be communicated in advance is perfectly understandable. This notwithstanding, we feel that said requirement constitutes a considerable departure from the present prudential supervision practices. Under the present policy, banks need to ensure certain automatic adjustments. Provided they stick to certain processes previously approved by the competent authority this

does not require any further prior consultation with the competent authority. In our view, the verification of the crisis period and thus potentially also the adjustment belong to the category of standard sub-processes during computation of the Stressed Value at Risk. A two weeks' notice to the competent authorities prior to applying the new stressed period creates an unnecessary additional workload for both sides, i. e. banks and competent authorities. In our view, any changes to the choice of the stressed period – most notably when this involves only minor deviations in terms of the result – should merely engender the need for an ex-post notification which is to be made during the notification of minor model adjustments that has to take place at least once a year.

Paragraph 9, Section 1
This section stipulates the need for a regular review ("on-going basis") in order to ensure that the specified stressed period is still representative for the portfolio. Given the fact that the impact of any changes to the choice of the stressed period was fairly limited even during the financial crisis, we feel that there is no need for such a review. We hold the view that the provisions on the rotating review or reviews triggered by certain circumstances (c. f. section 8) will be sufficient.

Paragraph 9, Section 3 and 5
Under the proposed provisions of Paragraph 9, section 3, new trading book positions leading to a material reduction of the Stressed VaR will have to be monitored. Based on our discussion during the public hearing on 13 December 2011 we think this means that the use of proxies during hedging transactions has to be accompanied by an appropriate reflection of the residual basis risk. At this juncture, we would welcome a clarification or, moreover, we would like to suggest replacing the first sentence of section 3 with the following wording: "Any material change in Stressed VaR should be analysed as is common practice with internal models. The results of the analysis should be taken into account in the review of the stressed period. "

The second sentence under section 3 should be deleted. The decision as to whether or not a position should be entered into the trading book ought to be left to the discretion of traders. For instance, due to operational reasons in the event of several thousands of individual trades per day in larger organisations, monitoring that an individual position was merely entered for the purposes of reducing Stressed VaR may become virtually impossible for risk controlling.

On a similar note, the second sentence under section 5 should be deleted because from the point of view of an individual institute, a banking comparison does not seem feasible.

Paragraph 10 - General
In our view this paragraph is further evidence for an increasing inconsistency between the VaR methodologies and the Stressed VaR calculation. This is a source of growing concern for us. We feel that this will only be warranted under exceptional circumstances. Hence, we propose a corresponding amendment.

Paragraph 10, Section 7
The present proposal stipulates the need to provide evidence for the fact that in sensitivity based risk calculations the approach for measuring risk is adequate and that this even holds true for the extreme values resulting from the stressed periods. However, since this period constitutes a historic period during which, more often than not, the VaR model will already have been in use, in our view this question is academic. After all, the above evidence will already been provided in the form of VaR adequacy. We therefore propose deleting section 7.

Paragraph 10, Section 7, 8 and 10
Section 7 and 8 spell out a preference for full revaluations in the context of Stressed VaR. There are two reasons why this gives us cause for concern: On the one hand this shall inform the approach towards risk measurement. On the other hand it means that VaR and the stressed VaR model will no longer be identical in terms of their calculation method, resulting in the deployment of two different risk models. We propose deleting the last sentence of section 8. For the very same reasons we propose deleting the item “use of Taylor series approximation” in the table of section 10.

Paragraph 13, Section 1
Section 1 requests a separate and complete review of the same proxies for the VaR and Stressed VaR estimate. This is extremely cumbersome and may lead to different and inconsistent models. Whilst there may indeed be individual cases where a separate analysis is appropriate, we still feel that this does not warrant a complete review. We propose deleting this request or at least introducing a materiality threshold.

Paragraph 15, Section 1 and 2
In the Stressed VaR, the current reference of the risk parameter is replaced by a historic one. As a result, portfolio management and thus the stressed VaR-based use test become more difficult. We therefore feel that monitoring stressed VaR at various levels of aggregation would be unconstructive. Also, it is not clear to us in how far this requirement deviate from the CRD III. We propose deleting the wording “at different aggregation levels”.

The rationale behind section 2 is not immediately evident. We suggest rewording this requirement: “The results of Stressed VaR should be taken into account in the regular validation process of the internal model.”

Specific comments on CP49

Paragraph 4, Section 3
To our preliminary understanding, uncertainty as to the level of returning cash flows from defaulted positions do not have to be included in the IRC modelling if and when they were already covered in VaR. Otherwise there would be a double entry which would lack any logical explanation. Furthermore, to our understanding, when it comes to IRC purposes, no stochastic modelling of LGDs is required under the IRC framework. Neither should such a requirement result indirectly or, moreover, implicitly. We propose entering a clarification at this juncture.

Paragraph 7, Section 3
To date, under the general rules, own issues did not have to be included within the scope of the IRC model. The present consultation paper, however, requests that own issues be taken into account during migrations, but not during default. If the current proposals were to be adopted, this re-interpretation would engender further model adjustments yet again. We kindly request a clarification why own issues shall now be included within the scope of the IRC model. Furthermore, the German banking industry recommends a modicum of consistency, at least with the Basel provisions (cf. Interpretive issues with respect to the revisions to the market risk framework", November 2011, page 6, question 10). Furthermore, we perceive the need for a certain consistency also with a view to the ICAAP. We suggest bearing this in mind during any paraphrasing exercise.

Paragraph 11, Section 3
Under the current proposals, the IRB quality steps may be applied for various external ratings. We propose a concept clarification what this means and possibly an incorporation of the legal reference.

Paragraph 12, Section 1
The use of different LGDs constitutes a tremendous challenge for many banks. To date, more often than not, estimating scenario based LGDs is not an option. Concerning the use of the downturn LGDs and the upswing LGDs it remains unclear at which level the calculation should take place: It would be possible to carry out such a calculation at position level, counterparty level or portfolio level. When it comes to prevention of an long LGD that exaggerates the risk, the present proposals beg the question as to how perfectly hedged positions should be handled. Furthermore there should be a clarification as to which one of the various LGDs (senior secured, unsecured, subordinated etc.) should be used. We therefore propose a clarification concerning the use of the LGDs.

Paragraph 13, Section 2
Section 2 stipulates the need for banks to use a time horizon for the correlation estimate which is "consistent" with the underlying liquidity horizon. We suggest elaborating this requirement further.

Paragraph 14
Under the current proposals, various multivariate probability distributions have to be tested. This places excessive demands upon banks' resources. It is a merely academic exercise which, in the absence of sufficient data, cannot be verified by means of real backtests. We therefore propose deleting this requirement.

Paragraph 15, Section 2
According to the draft guideline - in the event of liquidity horizons which are shorter than the capital horizon (i. e. with a roll-over) - the final value of a systemic risk factor at the end of the liquidity horizon should be the same as the initial value of the same factor at the beginning of the following liquidity horizon ("no refreshment of systemic factors"). This provision may potentially be in breach of the "constant-level-of-risk" requirement because it does not allow resetting the portfolio at the beginning of a liquidity period to its original risk level. We would appreciate a clarification.

Paragraph 17, Section 2
The proposal pursuant to which at least one own migration matrix for sovereign obligors will have to be developed does not take the lack of relevant data into account. In our view, any estimation of such a matrix is extremely instable; especially for the sub-investment grade area this means that there is a strong reliance on isolated rating changes. In our view there should only be a mandatory own migration matrix if and when the available relevant data allows their development in a meaningful manner. We therefore propose adding the words "if the relevant data allows for it" at the end of the last sentence.

Paragraph 17, Section 4
Under the provisions of the present consultation paper, the assumptions underlying a migration matrix with a short horizon should become subject to back-testing. In our view a request for validation would be more appropriate in this context. We therefore propose using the term "validation".

Paragraph 18, Section 4
Under the present proposals, institutions only need to model the unexpected loss over the capital horizon or when rebalancing the portfolio after expiry of the liquidity horizon. After the discussion during the public EBA hearing held on 13 December 2011 we think that this means that based on the positions at the beginning of the liquidity horizon, value changes of the portfolio may be calculated by assuming instant price changes based on the positions at the

beginning of the liquidity horizon; to our current understanding the consideration of maturity effects shall not be mandatory. We would appreciate a clarification.

Paragraph 20, Section 1
In the first sentence, rating changes have to be converted into spread changes. To our understanding this has to read "price changes" instead of "spread changes". We would like to propose a corresponding correction.

Paragraph 20, Section 4 and 5
Under the provisions of CRD III, during a complete revaluation after a rating change, spreads or historic PDs may be discounted. We assume that this room for discretion is also in line with the rationale behind this consultation paper.

To our preliminary understanding the option of including "upswing estimates" means that such estimates should be used during a foreseeable upswing. A potentially required simultaneous computation of "downturn" and "upswing" LGDs is not feasible. As has been mentioned above, at present, institutes are incapable of implementing these provisions which, besides, would also lead to an inadequate risk picture.

Paragraph 22, Section 1
The rationale behind the preference given to a liquidity horizon at the level of product or issuers is not immediately obvious. Such a granular vision is not in line with the current practice under which clusters shall be formed on the basis of product type, issuer type, rating or concentration. The disadvantages of choosing the liquidity horizon at product level would be further compounded due to the fact that the rating always depends on the issuer: Upon expiry of the liquidity horizon, part of the positions of an issuer would see a reset back to their original state and part of these positions would not see such a reset. As a result, *de facto* the next simulated period would see the emergence of two issuers with diverging rating processes.

Yours faithfully,

On behalf of Die Deutsche Kreditwirtschaft
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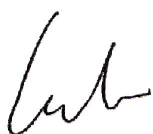
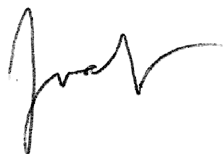
[National Association of German Cooperative Banks]





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