

Banking Stakeholder Group comments on EBA Draft Regulatory Technical Standards on the conditions for assessing the materiality of extensions and changes of internal approaches when calculating own funds requirement for credit, market and operational risk under articles 138(5), 301(3)(a) and 352(3)(a) of CRR (EBA/CP/2013/02)

The EBA Banking Stakeholder Group (BSG) welcomes the opportunity to provide comments to the EBA consultation paper on draft regulatory technical standards on the conditions for assessing the materiality of extensions and changes to internal approaches when calculating own funds requirement for credit, market and operational risk.

The response is divided into two parts where the first part contains general comments and the second part contains responses to the questions outlined in the consultation.

General comments

In general we support the efforts of harmonising and clarifying the conditions for assessing the concept of materiality. In our view it is essential to have a clear and common view for deciding when an application is needed and in the interests of competitive neutrality that view should not differ between different supervisors.

Even though we support the harmonisation there are a number of general issues we would like to raise. Firstly, there are some areas where the RTS is not sufficiently clear, e.g. for which models this RTS is to apply and how the consolidation for the calculation of the quantitative thresholds should be done.

Secondly, we do agree with the principles of categorization of extensions and changes, but for market risk we believe that too much emphasis has been placed on the quantitative identification and documentation. This will cause a rigid “approval” framework which will hamper the ability for financial institutions to, on an on-going basis and in a timely manner, adjust their modelling framework to external changes as well as changes in regulatory policy. The quantitative impact analyses are burdensome, implying significant IT developments and dedicated departments within the banks. There is also a risk that the institutions, especially for IMA, would need to make thorough analyses and calculate the quantitative impact for all cases even for minor changes only to be able to secure that there is no need to make an analysis in the first place and independent on whether they translate into a capital increase or decrease. Our view is that there should be an additional paragraph in the RTS stating that if there are sound reasons to assume that the effects of the changes or extensions are minor, or if the effect is to require a capital increase, there should not be any requirement to make a thorough quantitative impact analysis. Furthermore, as regards changes to the AMA framework, as a lot of items given are qualitative, assessing the aggregate impacts on operational own funds appears impossible. Producing the documentation as it is currently described in the draft RTS would require

significantly more resources. This is an issue of proportionality to which regulators are committed.

Thirdly, we find it cumbersome as well as irrelevant to supplement all applications for material extensions and changes with a detailed plan for the notification (before and after) of all (other) exchanges and changes planned for implementation over the next 12 months. From an IRB framework perspective it is our belief, that all proposed extensions and changes should be evaluated on their own merit. By requiring the production of a list of planned implementations expected over the coming 12 months, the ability to regard the proposed extension or change on its own merit is hampered. Experience has shown that a change to priorities combined with development challenges makes a 12 month plan only indicative at best.

Fourthly, we judge that there are a number of weaknesses in the qualitative lists:

- The qualitative lists do not deal with cases where the changes or the extensions are done in order to meet a supervisor's recommendation or request.
- The qualitative lists of extensions and changes to internal models are very general in certain cases, and could lead to different interpretations.
- Regarding operational risk, the wording of the qualitative lists is, in some cases, not precise enough. Furthermore, most of the changes displayed in the qualitative list deal with the operational risk framework (change in organization, changes in the frequency or recipient of dashboards, changes in budget, etc.) and cannot be quantitatively assessed. Thus they should not be covered by the quantitative threshold provision.
- The level of communication (approval, ex ante notification, ex post notification) and the nature of the change or extension of a model are not always very pragmatic. For example, 'the change in the data' (i.e. the price for market risk, this data is the same whoever the provider) requires an ex ante notification while this kind of situation is often due to the disappearance of a data provider, being beyond the control of the credit institution. To change the data source could prove too complex to organize if, additionally, an ex-ante communication toward the supervisor must be foreseen before the implementation.

Fifthly, while all extensions and changes are subject to internal governance and the approval processes, producing the documentation required for a formal application to the regulatory authority requires resources which may in some cases be particularly onerous. We believe that producing formal applications to the supervisors requires significantly more resources not only in formulating the application, but also in the dialogue phase while the application is being processed which means that it will draw heavily on resources in both institutions and supervisory bodies. Also for the notification process, documentation will be needed as support. It is therefore our view, that the required documentation to support a notification before implementation and to support post implementation information will be excessive, and disproportionate in relation to any potential advantages. In our view a too burdensome processes will give the wrong incentive to banks, whereas they should be encouraged to continuously improve their internal models.

Sixthly, the communication framework towards the supervisors, as described in the consultation paper, is not flexible enough compared to the current process used by most regulators:

- The number of cases for which an extension or a change requires an approval is much higher.
- In most countries, only two levels exist: the formal approval and the notification ex post.
- No systematic quantitative impact is required.

Finally, there is a lack in the consultation paper of information concerning the supervisor's duties:

- Banks are required to respond quickly to economic change and to maintain internal models as risk-sensitive as possible. If, however, the regulator is not required to respond within a certain timeframe, the demand for reactivity to the economic environment cannot be met. For example, regarding credit risk, an economic downturn affecting a specific population could translate into the need for the LGD recalibration to maintain the relevance of the IRBA model. An approval from the regulator is then requested. If no clear deadline for the answer is stated, the bank will be forced to maintain an inappropriate model for a long period of time. As a consequence, the capital consumption could be significantly under-estimated compared to the actual risk. It is therefore our view that banks should be allowed to implement model changes if no answer has been received within a reasonable and stated timeframe (as foreseen in some jurisdictions).
- The respective role of the home and the host regulators, especially when the host is not in Europe, needs to be clarified.

Answers to the specific questions

Q1: Are the provisions included in this draft RTS that specify the principles of categorisation of extensions and changes, sufficiently clear? Are there aspects which need to be elaborated further?

In our view it is not sufficiently clear for which models this RTS is to apply. It is only IRB, AMA and IMA that are mentioned in the RTS. Does this RTS not also include other internal models (e.g. the Internal Method Model for Counterparty Credit Risk)?

Q2: Are the provisions included in this draft RTS on the calculation of the quantitative threshold for the IRB approach sufficiently clear? Are there aspects which need to be elaborated further?

In our view the consolidation for the calculation of the quantitative threshold of 15% is not sufficiently clear. It needs to be further elaborated on what portfolio/consolidated level the calculation should be done.

Q3: Do you support the calculation proposal of the quantitative threshold for the IRB approach in terms of design of the metrics and level of thresholds? (Please also take into account the arguments provided in Tables 2 to 5 of the Impact Assessment)

Whilst the quantitative threshold applied to group level is appropriate, the supplementary sub portfolio level is not appropriate as it opens up for many borderline issues. In fact, any portfolio

in scope could be limited to a level where the threshold always will be breached, why the range of application needs to be clarified.

Q4: Do you support for the IRB approach the three month period for notification of the changes before implementation?

Three months seems to be an unnecessary long period for banks to wait with the implementation of changes. One month seems to be a more reasonable time period.

Q5: Are the provisions included in this draft RTS on the calculation of the quantitative threshold for the AMA sufficiently clear? Are there aspects which need to be elaborated further?

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Q6: Do you support the calculation proposal of the quantitative thresholds for the AMA in terms of design of the metrics and level of thresholds? (Please also take into account the arguments provided in Tables 2 to 5 of the Impact Assessment)

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Q7: Do you support for the AMA the three month period for notification of the changes before implementation?

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Q8: Do you support that for the AMA no quantitative differentiation between changes requiring notification prior vs. post implementation is made?

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Q9: Are the provisions included in this draft RTS on the calculation of the quantitative threshold for the IMA sufficiently clear? Are there aspects which need to be elaborated further?

Yes, the provisions are clear.

Q10: Do you support the calculation proposal of the quantitative thresholds for the IMA in terms of design of the metrics and level of thresholds? (Please also take into account the arguments provided in Tables 2 to 5 of the Impact Assessment)

Having in mind the high volatility in the results from BIS analysis of risk weighted assets for market risk, a threshold of 10% change in the model calculation result in a risk measure seems quite low. We would expect that the majority of model extensions and changes (including many of the extensions and changes mentioned in appendix 3 part I, title II and part II, title II) would trigger this threshold and thereby be categorised as material.

Further, the analysis required for minor changes to ensure that no thresholds are exceeded would be extensive. It is our view that there should not be a threshold for the specific IMA model. The relevant effect to consider should instead be the change in capital requirement as a percentage of a bank's total capital requirement for market risk. Given the volatile nature of IMA charges, our suggestion is that this threshold should be 10%, not the proposed 5%. A 5% threshold would imply that too many model changes of non-material nature were to be treated as material vis-à-vis national supervisors. Not only would this be an undue burden on banks, but supervisor would also risk being faced with spending considerable resources on these processes. This is resource demanding both in terms of personnel and IT and it would also slow down the process of making gradual model improvements.

That just one of sixty calculations exceeding a 10% change should trigger a process vis-à-vis the supervisor according to the approach for material changes seems excessive. This will significantly increase the number of applications which will draw heavily on the resources of both the supervisors' and the institutions.

Q11: Do you support for the IMA the one month period for notification of the changes before implementation?

The period seems long, in particular when the requirement of a 60-day comparison period is added. To ensure that banks are able to react with appropriate promptness to risk management needs and business initiatives, all non-material extensions and changes should be subject to ex-post notification requirement. The one month period unduly slows development of model improvements. Also, occasionally banks will discover undesirable features or even errors in their models. A one month delay in implementing such a correction would be highly unfortunate.

Q12: Do you support for the IMA the 60-day observation period for the purpose of comparing the modelling result before and after a proposed change?

We acknowledge the value of assessing the impact of an extension or change based on several observations, but we cannot support the proposal for a 60-day observation period. It is our opinion that this will impose an unnecessary delay to the implementation of changes and hamper institutions ability to implement risk management improvements in a timely manner. It will also be unnecessarily burdensome for smaller changes resulting in insignificant changes in capital. Furthermore, we find it difficult to see the additional benefits to support a 60-day period as oppose to a shorter period. We therefore suggest a much shorter period or alternatively spot checks of the impact of changes over a 60 day period.

If EBA does decide to keep the 60-day observation period, it is unclear how a bank is to do impact assessment for improvements running in parallel. Should each improvement be assessed separately during the 60-days period, or should they run in consecutive periods?

Q13: Do you support that for the IMA for those modelling approaches which are only required to be calculated once a week (stressed VaR, IRC, CRM) to compare only twelve numbers for Article 7 paragraph 1(c)(iii)?

An assessment based on 12 weekly observations will, in line with the 60 days period mentioned under question 12, hamper institutions ability to implement risk management initiatives in a timely manner.

Q14: Do you support that for the IMA no quantitative differentiation between changes requiring notification prior vs. post implementation is made?

It is our view that there should be only one category of immaterial change and that there be only ex-post notification.

Q15: Are the provisions included in this draft RTS on the documentation requirements sufficiently clear? Are there aspects which need to be elaborated further?

It is our general view that the required documentation to support a notification before implementation and to support post implementation information are excessive.

It is unclear what exactly is expected to be the content of the documentation of the scope of application affected by the model extension or change (Article 9, item 1(c)). This needs to be specified and it would be helpful to provide examples.

It is also unclear what kind of documentation institutions are expected to present in response to article 9, item 1(h). This needs to be specified.

The requirement to present the planned changes for the coming 12 months (Article 9, item 1(i)) also needs to be clarified. To what extent are institutions locked/committed by what they have previously reported? Does this imply that institutions are not able to introduce changes that have not previously been presented in their twelve months plan? It seems to us that this would be unreasonable, why it is our view that it should be clearly stated that the information does not prevent banks from changing priorities if there are good risk management or business initiative arguments for this.

We firmly believe that it would have the effect of significantly reducing the ability to react to changes in financial markets since plans can change rapidly due to changes in market conditions and changes in market practice. It could increase the gap between risk models used for internal risk management purposes and the models used for regulatory purposes, since institutions will not be able to implement changes when they are needed.

Q16: Do you support the view that costs arising for institutions from the documentation requirements included in the draft RTS are not expected to be material? If not, could you please indicate:

- the main cost driver: i) additional IT equipment, ii) additional on-going Staff/hours, iii) other (please specify).

- the % increase in total yearly costs of internal models management for credit/operational/market risk induced by the proposed documentation requirements (specify whether the costs arise only for some of the risk categories covered by the provisions).

- indicative monetary amount of these additional costs (specifying currency and unit)

Q17: Do you support the view that the additional costs, for institutions, of computing the quantitative impacts of the implemented model extensions/changes are expected to be non-material, given that institutions already carry out impact analysis in the current framework? If not please indicate:

We believe it is reasonable to assume that the additional costs of computing the quantitative impacts and associated with impact analysis on extensions and changes both to the IRB framework and the IMA framework will be material. Also, additional costs associated with ex-ante/ex-post notification of extensions/changes will increase significantly. In particular, the requirement to have a 60 day quantitative impact study will lead to a substantial increase in IT costs as it will necessitate a considerable upgrade of system capacity. Besides the costs this will

also increase the operational risk when IT resources need to be allocated to these impact analyses.

- the main cost driver: i) additional IT equipment, ii) additional on-going Staff/hours, iii) other (please specify).

The additional cost will be driven by increased IT and human resources costs.

- the implied % increase in total yearly costs of internal model management for credit/operational/market risk induced by the quantitative impact analysis (specify whether the costs arise only for some of the risk categories covered by the provisions).

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- indicative monetary amount of these additional costs (specifying currency and unit).

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Q18: Do you support the view that, for institutions, the costs of ex-ante/ex-post notification of extensions/changes are expected to be non-material? If not, please indicate:

- the main cost driver: i) additional IT equipment, ii) additional on-going Staff/hours, iii) other (please specify).

- the % increase in total yearly costs of internal models management for credit/operational/market risk induced by the notification requirements (specify whether the costs arise only for some of the risk categories covered by the provisions).

- an indicative monetary amount of these additional costs (specifying currency and unit).

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