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British Bankers' Association response to EBA Consultation Paper on Draft Regulatory Standards on the conditions for assessing the materiality of extensions and changes of internal approaches when calculating own funds requirements for credit, operation and market risk

Introduction

The British Bankers' Association[1] ("BBA") is the leading association for UK banking and services representing members on the full range of UK and international banking issues. It has more than 200 banking members that are active in the UK, which are headquartered in 50 countries and have operations in 180 countries worldwide. All the major banking groups in the UK are members of our association as are large international EU banks, US and Canadian banks operating in the UK and a range of other banks from the Middle East, Africa, South America and Asia, including China. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum from deposit taking and other more conventional forms of retail and commercial banking to products and services as diverse as trade and project finance, primary and secondary securities trading, insurance, investment banking and wealth management. Members include banks headquartered in the UK, as well as UK subsidiaries and branches of foreign banks, many of which will have operations in the United States, and on behalf of all of which the BBA is pleased to respond.

The BBA welcomes the opportunity to comment on the Draft Technical Standards entitled "Consultation Paper on Draft Regulatory Technical Standards on the conditions for assessing the materiality of extensions and changes of internal approaches when calculating own funds requirements for credit, operational and market risk under articles 138(5), 301(3)(a) and 352(3)(a) of Regulation (EU) XX/XXXX of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms [CRR][2]."

Key points

The BBA acknowledges the goals of the EBA to specify conditions for assessing the materiality of extensions with these draft regulatory technical standards. In particular we welcome the EBA's consideration of reducing the burden to prepare notification for changes of minor importance.

We however have some comments on the wider impact on the assessment of internal model suitability and quality.

The BBA would like to highlight our key concerns:

- The proposals focus predominantly on the impact of models changes on Risk Weighted Assets (RWA). There should be explicit reference to the fact that the banks' motivation for making changes is to improve model performance and suitability. The EBA should balance the need of supervisors to assess changes to models that may result in significant changes in regulatory capital requirements with the ability of banks to implement on a timely basis enhancements that would result in improved model performance. The whole rationale of the Internal Ratings Based (IRB) models is compromised if model change proposals remain 'in limbo' for indeterminate time.

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[1] Registration ID in the Transparency register: 5897733662-75

[2] http://www.eba.europa.eu/cebs/media/Publications/Consultation%20Papers/2013/CP-02/EBA-CP-2013-02-CP-on-RTS-on-materiality-of-model-extensions-and-changes.pdf

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- One of the issues with the current process is that the materiality of the change is more important than the materiality of the model. As a result firms can make a material change to an immaterial model which would then require pre-approval from a competent authority. It would make sense to have some quantum around the change and the model to ensure that we are not requesting pre-approval for models with minimal RWA change (e.g. 0.1% of total RWA). Alternatively we could have a 'de minimis' category where we can make any changes.

- We encourage communication with competent authorities to clarify how they will adopt the technical standards and whether this is a standard that will be adopted across the EU.

- Competent authorities should establish service level standards in responding to model extension notifications and applications. This communication is critical for the planning of implementation time frames. If there is a three month review period, for example, the authorities should inform the bank within a shorter time period (for example within 10 working days) whether they will review the model or not.

- Ensuring there is clarity for IRB model extensions of how the quantitative criteria are applied for EU subsidiaries of an EU Parent where the EU subsidiary is in a different member state to the parent. In particular is the quantitative test solely based on the own funds / risk weighted exposure at the EU parent level? Clarity on this issue will be important for home/host supervisors and for the firms operating across the EU.

- For the quantitative backstops applied to IMA, the proposed 60 day comparison period for the materiality assessment would impose an inappropriate level of operational burden on institutions and the justification for the selection of this period is not supportable. Regarding the operational burden, the 60 day period would effectively require parallel running of original and revised models over a more extended period than the one currently implemented by the PRA for parallel run purposes. As capital is calculated using a 60 day history of VaR, in order to produce the capital numbers for 60 days as specified in the draft RTS a total history of 120 days of VaR is required. This can mean a 120 day delay from implementing a model change to approval, even if the regulator responded immediately to the notification. Even if a few estimate capital numbers are accepted, based on say single day numbers rather than the 60-day averages then a 60-day lag is still too long

  The proposed 60 day length comparison period has been based on 'the period over which the daily modelling results are to be averaged to calculate regulatory own funds requirements' as 'the portfolio subject to the IMA can change significantly every day'. This is not an appropriate justification for selection of the comparison period length to address the potential variability of the impact of an IMA model change. The Regulatory Technical Standards should instead permit a more flexible approach allowing institutions to use an appropriate approach to estimate and illustrate the range of potential capital impacts of the model changes from typical portfolio variation.

  In the UK, 5 consecutive day calculations have been considered adequate and we would like to maintain this. Indeed, if materiality has been determined for one day this will be sufficient to demonstrate materiality and any additional calculations are no longer necessary for a materiality assessment. This is of course different for the assessment of model approval.

  We suggest that a Point in Time capital measure (PiTCM) be used to determine materiality but subsequently a change in capital requirement is reported for material changes/extensions. By PiTCM, we mean the sum of VaR, stressed VaR, IRC, CRM and other risk-sensitive add-ons (e.g. RNIV) with multipliers as appear in the risk-sensitive part of the capital equation/model. Note that the capital requirement is an average/maximum combination of this number over 60 days/12 weeks.

  A practical process is as follows;
  1. Measure PiTCM over 5 days – if any day breaches the threshold then the change is considered material and the change in capital requirement must be reported as part of the documentation (article 9, point 1g).

2. PiTCM must be reported *and explained* with supporting analysis. This is so that the ongoing impact can be understood e.g. volatility of some risk is increased and the risk is uncorrelated with the rest of the portfolio e.g. LGD for G4 Sovereigns has been increased by 10% but our exposure is small, in line with the firm's strategy.

3. Breaching the materiality threshold requires treatment under the "material change/extension" process. However, competent authorities should be at liberty to "upgrade" scrutiny in the light of an impact assessment and explain described in point 2 above.

- The comparison of capital savings is not a fair measure. If two firms make a change to arrive at the same model calibration then both should receive the same response however if firm A started with a more conservative model than B then A would have a larger reduction in capital and may get penalised. It is not unreasonable that regulators look at capital savings in the absence of any other metric but through other forums (BIS Fundamental Review of Trading Book[3] for example, and potentially in the BIS RWA variability exercise[4]) industry groups are contemplating the idea of standardised models and this may be pursued independently from this consultation.

- Some of the IRB model qualitative criteria that in the draft are subject to three month pre-notification have an impact on the banks' operations and lending practices; these should not be subject to pre-notification, but shifted to the category of 'post notification'. These are:
  - Page 22 – Title II (2)(g) changes in the rules and processes for the use of overrides, … …
  - Page 23 – Title II (4) changes in processes. These include:

    (a) changes in the credit risk control unit as regards its position within the organisation and its responsibilities;

    (c) changes in the internal organisational or control environment or key processes that have an important influence on a rating system;

    (d) changes in the lending practices, lending standards or process for pursuing recoveries with the potential of rendering the rating system no longer suitable;

- Similarly, the IMA model qualitative criteria in Annex 3 part II, total II paragraph 17 requiring ex ante notification are linked to a banks organisation and operational structure. These changes should not be subject to pre-notification, and should be revised to the category of 'post notification' except in exceptional cases where the changes are fundamental.

- The qualitative criteria in Part II Title II (7) on page 23 is very unclear in its purpose and the scope of models it is intended to cover. A bank should be allowed to implement changes to their internal models used for business purposes without pre-notification. The use test aspect can be achieved without requirement to pre-notify.

- On the quantitative thresholds: We note that firms are required to aggregate the impact of a change. Article 2 (3) states that "Institutions shall also assess aggregate impact of that particular extension of change together with the impact of all other extensions or changes which are triggered by the same underlying reasons....". What would be the definition of the "range of application of the internal rating system" for an international bank with country specific models? Taking into account Article 2 (3), would this be at country level or at the business unit level?

Questions asked in the consultation

We offer comments to specific questions asked in the consultation below:

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[3] See http://www.bis.org/publ/bcbs219.pdf
[4] See http://www.bis.org/publ/bcbs240.htm

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?

Please provide additional clarity on whether there are any additional options for exclusion from the pre or post notification process i.e. De minimis category list.

CRR IV Article 352(2) and Annex 3 ('Extensions and Changes to the Internal Model Approach') clearly set out the categorisations. We do however have some points to raise:

IMA Quantitative Impact

- Article 2, Para 2(a): reference to the use of 'most recent data available' should be replaced by a more specific requirement, such as 'at the most recent quarter end'.

- Article 7, Para 2 is unclear with regard to the average impact over 60 days (see our response to Q12).

- Technical decisions, Table 5: different backstop thresholds. Option 1 is over-complicated "consolidated/stand alone, sub-consolidated and scope of application" (see our response to Q12).

IMA Date of Implementation

- Article 2, Para 5: the reference to the non-implementation of an approved change requiring further approval is impractical. There are often unavoidable reasons why a change may not be implemented on the specified date e.g. reprioritisation, technical failure of the final roll-out stage, IT freezes, bug fixes. A grace period, say, 12 months would be appropriate.

IMA Proxy risk factors

- Annex 3, Part II, Title II (7) "changes in the definition or methodology of appropriate proxy risk factors for VaR. We understand this to refer to a change in an approach and not to mean individual choices of proxy.

- Annex 3, Part II, Title II (10) "changes in the methodology for defining appropriate proxy spreads for VaR or CVA". We understand this to refer to a change in the approach and not to mean individual choices of proxy.

IMA Material Changes, Qualitative Criteria

- Annex 3, Part II, Title I (3) "inclusion of material risk factors beyond those necessary when the model is extended to new product types". We would say that material risk factors are always necessary.
- Annex 3, Part II, Title I (1) and Annex 3, Part II, Title II (5) "changes in the calculation of the effects of changes in market risk factors on instruments". This is stated twice even if the examples given are different.

IMA Less Material Changes, Qualitative Criteria

- Annex 3, Part II, Title II (1) "changes in the fundamentals of statistical methods". We understand the spirit of this category to include scenario generation methodology for Historical Simulation VaR models as an interpretation of (c) applied to Monte Carlo models.

IMA Pricing model changes

- Annex 3, Part II, Title II (14) "implementation of internally developed and implemented pricing models or use of proxy models", We understand this does not include changes in pricing models, when a full revaluation approach is always in sync with changes in pricing models.

IMA Changes of Lesser Materiality

- Annex 3, Part II, Title II (17) "change to organisational and operational structure of risk management and internal governance process" (d) stress testing changes. We understand this to mean a change in the governance such as review and signoff, or a change in operations such as moving from Greeks to full revaluation and not changes in the definitions of individual stresses, other than significant changes in the approach to calibration affecting at least one asset class.

- Annex 3, Part II, Title II (17) “change to organisational and operational structure of risk management and internal governance process” (d) internal organisation and staff changes. We understand this does not apply to individual staff moves, but does apply to re-organisations such as moving sub-departments in/out of a market risk management function.

IMA Annex 3, Part I, Title II – Changes of Lesser Materiality
We suggest a higher level of scrutiny for;
4) Change of length of historical period or weighting scheme. This is a very significant change to a VaR model so we propose it always be treated as a material change. The impact can appear small during benign periods.

We suggest post-notification for;
3) Choice of risk factors, grid points and extended surfaces

9) Mapping of positions to risk factors
14) Changes to implementation of pricing models

IMA - Exclusions
In order to facilitate focus on model changes/extensions which have, or are likely to have material impact on capital requirements we suggest that some changes/extensions are excluded from the scope of the RTS.

- Extensions or changes demanded by the competent authority.
- Changes made at the request of the Independent Validation Team.
- Regular calibration updates such as beta model parameters, or the volatility and correlation matrix for Monte Carlo VaR
- Changes in pricing models, Annex 3, Part II, Title II (2), (5) and (16).

Some explanation of the final bullet above is in order. Risk follows pricing: changes to pricing models that do not require a change to the VaR/IRC/CRM model are subject to a different governance process. For example a full revaluation approach to VaR will use production pricing models and so necessarily be consistent with the latest version. The firm has an obligation to use the most appropriate pricing models for books and records, and should reflect and change immediately in VaR/IRC/CRM immediately.

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?

The quantitative thresholds are predominantly clear. It would be practical if members could align the figures used for RWA exposure amounts in the calculations to the financial institutions quarterly reporting as this simplifies the financial extract from underlying reporting systems.

Page 12 Article 2 (3) states that “Institutions shall also assess aggregate impact of that particular extension of change together with the impact of all other extensions or changes which are triggered by the same underlying reasons”. What would be the definition of the “range of application of the internal rating system” for an international bank with country specific models? Taking into account Article 2 (3), would this be at country level or at the business unit level?

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)

See comments above for Q2.

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

We support the three month period for notification however this is with a strong caveat that competent authorities manage the communication to institutions to provide responses within a reasonably timely

manner or ideally agree timeframes of when they will respond. This is essential for members to plan any implementation and any process lead times. Where competent authorities require additional review or information this should be highlighted immediately to the firms. We recommend that competent authorities are also provided standards or best practice guidelines with regards to response times to reduce the uncertainty that banks have between application and three months to elapse. Additionally, it appears that if all proposed ex ante qualitative rules were applied, virtually all changes will fall into this pre notification, Is this intention of these rules?

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?

We need to understand what "recent data" means with respect to the threshold for AMA. For AMA it may be more appropriate for "relevant" rather than recent data. Does "recent data" include changes to hierarchies and group structures?

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)

Yes, these quantitative thresholds are acceptable.

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

Whilst well intentioned there is a significant risk that a three month pre notification increases risks as it does not allow firms to adapt their risk management operations to a changing business environment. This is in particular the case for Annex 2 Title II, (1-3, 5b, 6, 7).

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

Yes, but caveated as to whether changes to business areas where we have structural changes and merging/consolidation of operations are classified as a major structural change to the model.

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 quantitative thresholds for the IMA are clear, with the exception of the scope of Article 7, 2 (iii).

We request further clarification on what is meant by "the model calculation results associated with the scope of the specific model" and in our response to Q10 propose alternative measures.

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)

We would be grateful for further clarification of the "risk categories". Article 352 states that this refers to:

a) General risk of equity instruments
b) Specific risk of equity instruments
c) General risk of debt instruments
d) Specific risk of debt instruments
e) FX risk
f) Commodities risk

Table 2: we support the inclusion of qualitative as well as quantitative criteria in order to capture significant changes to the modelling approach. This is because such changes may give rise to material differences in the future as a firm's portfolio mix changes.

Table 3: we advocate the exclusion of standard rules capital from the denominator of the change calculation set out in the Table on page 18. In other words, the denominator would only include "modelled capital" meaning VaR, sVaR, IRC, CRM, RniVs and any other risk-sensitive non-VaR type capital add-on that has been subject to approval by a competent authority. This represents a tightening of governance standards in the interests of avoiding a meaningless measure of materiality "polluted" by non risk-sensitive standard rules calculations. While including standard rules capital gives the right capital impact, it is a very poor indicator of the importance of a change in the "model" to the "model" itself.

Supposing that standard rules represents ½ the capital requirement the threshold should be set to 10% to be consistent with Option 1. This firm would be comfortable with the original 5%, although that corresponds to Option 2 – lower (or "tighter" thresholds), as it already applies a similar standard however the EBA is encouraged to consider the range of firms affected.

Article 7 1.(c)(iii). We advocate no different treatment for model changes capturing specific risk i.e. materiality should be based on the change compared to total modelled capital. The reason is to remove any possibility that a firm might attempt to manipulate the estimate of materiality by adjusting scope of applicability. A change to the IRC/CRM model is best measured in terms of the change in IRC/CRM itself and a 10% threshold is appropriate. A change affecting both IRC and CRM should be measured compared to the sum.

Table 5: Option 1 is over-complicated. Option 2 is open to manipulation by adjusting the scope of applicability. We recognise the disadvantage of Option 3 but feel we have addressed it by advocating the removal of standard rules capital in the denominator of the materiality measure.

Are granular categories being considered such as inflation, emerging markets, asset-backed, etc? More generally does the definition of debt instruments include derivatives on debt products or debt indices?

The classification of materiality to include changes in the calculation of the effects of changes in market risk factors feels more restrictive e.g. if a bank includes a risk factor which it had covered before under RNIV into the VaR model, the bank may add greater granularity in the model (e.g. tenors). Would this require PRA pre-approval? It seems this would fall under ex-ante notification according to point (3) on page 28 of the consultation paper.

Also, is the RNIV calculation itself considered part of the model, such that any new RNIV would have to be pre-approved by the regulator?

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

The one month period is appropriate for crucial issues that require pre-notification and approval. However the list included in the consultation goes far beyond this and needs to be shortened significantly to achieve regulatory objectives. Moreover, in the case of pre-notification the institution should be capable of reversing the change if needed.

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?

No, this implies a 120 day period of measurement (as the text stands, although we may have misunderstood the intention). The capital requirement already is a 60-day average (VaR/sVaR) or 12-week average (IRC).

We welcome the proposal to allow an estimate of impact (which should be accurate, but not necessarily precise) where a detailed and precise assessment (i.e. parallel run) is not economically feasible (Article 2, 2b).

See further comments on page 2 on this topic.

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)?

As for question 12 above, the principle of using the 60 day period is not appropriate for addressing the potential variability of the impact of an IMA model change and lead to unnecessarily increasing the number of calculations.

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

Yes, however we recommend the EBA reviews the split between the two to achieve a more appropriate balance.

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

Article 9, Para 1(i) is impractical. It is unlikely that members are to be able to provide, 12 months in advance, details of all planned changes for internal models where own funds requirements are expected to change materially (given our recommendation of a tighter threshold) other than incorporation of specific risk or new asset class extensions.

However, if a best efforts list of changes continues to be required we suggest a template could be provided to enable consistency of format and approach i.e. similar to what was provided as an Appendix C from the PRA.

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 ongoing Staff/hours, iii) other (please specify).*

We disagree and view that there are substantial cost drivers inherent in the proposal. The main cost driver will be the increased operational risk stemming from the divergence between risk systems and regulatory systems. There will be substantial additional cost in terms of achieving compliance, particularly if information is required to an auditable standard. Increased costs in order of magnitude:

- Delays to model upgrades
- Additional ongoing staff/hours in all areas
- Additional IT equipment

There is also an unknown but potential cost from regulatory distraction as management focus switches even more in the direction of compliance and away from risk management.

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:

- the main cost driver: i) additional IT equipment, ii) additional ongoing Staff/hours, iii) other (please specify).
- 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).
- indicative monetary amount of these additional costs (specifying currency and unit).

The additional costs are expected to be material for some of our members. This impact would be significantly increased if regulators globally undertake a non-equivalent approach in which case a doubling of effort (additional ongoing staff/hours) to satisfy dual reporting as a minimum is not unrealistic.

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 ongoing 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).

Many of these proposed changes would significantly increase the number of pre-notifications compared to the current regime and therefore increase costs substantially. Please also see our response to Q16.

Please contact the following if you have questions arising from our response:

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