ABI Position Paper on EBA document: “Draft Regulatory Technical Standards on the Specification of the Assessment Methodology for Competent Authorities Regarding Compliance of an Institution with the Requirements to use the IRB Approach in accordance with Articles 144(2), 173(3) and 180(3)(B) of Regulation (EU) No 575/2013”

March 2015

POSITION PAPER

Introduction

Generally speaking, the RTS clarify the competent authorities' expectations on several issues concerning internal rating system methodologies and processes.

In overall terms, the provisions of the EBA document set out the key points of the Competent Authority's interest in the IRB systems, with particular regard to governance, process, model, data quality and IT issues, as well as planning aspects (e.g. roll-out). Given the broad scope of the provisions, a stringent, immediate implementation could have significant effects on those institutions that have already defined a roll-out plan, and whose national regulators have already validated their IRB systems. In this context, it may be appropriate to verify the possibility of defining a multi-year convergence process through which the institutions can complete the adaptations in line with the roll-out plan, also in the light of the upcoming discussions with the Joint Supervisory Team, and with regard to the specific situations currently affecting each institution. Looking specifically at the individual issues, the following aspects are important:

- Multiple defaults: standard guidelines may be useful, in terms of timeframes, for the handling of multiple defaults.

- LGD estimation: there could be better specification of the reason why the LGD should be a "forward-looking economic loss" (for example, there is the question of whether this issue could relate to discount rates).

Moreover, we note that on several topics covered by the RTS, the EBA is expected to introduce additional standards or guidelines in the forthcoming months (e.g. definition of default, downturn, etc). We recommend that the new regulations be developed according to a plan ensuring consistency across the various releases envisaged.

Q1: What views do you have on the nature and appropriateness of the proportionality principle in Article 1(2)?

The proportionality principle should be better explained in various parts of the document. For example, a request such as the one about verifying implementation (for default positions) of LGD estimates that “take into account the information on the time-in-default” (Art. 54.2.b) should clearly be considered only for organizations of a particularly relevant size and complexity, for which the rating system may have developed this kind of feature.

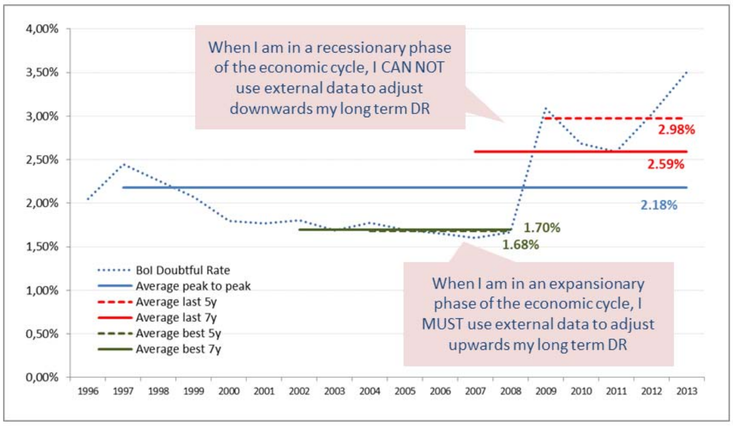
Q2: Do you agree with the required independence of the validation function in Article 4(3) and Article 10? How would these requirements influence your validation function and your governance in general?

Q3: Are the provisions introduced in Article 49(3) on the calculation of the long-run average of one-year default rates sufficiently clear? Are there aspects that need to be elaborated further?

Several economic variables could be used when evaluating an entire economic cycle: for example, the presence of two peaks in the GDP trend (one positive, one negative), representing the growth and recession phases, or, simply, a reversal of the economic trend measured by GDP, from positive to negative or vice-versa. We ask that there is a better definition of the full economic cycle, in order to ensure greater consistency of definition.

As far as we can understand, the proposal introduces an asymmetric approach as, in a recessionary phase of the economic cycle, the recently observed internal default data, higher than the long-term average, are a floor, while in an expansionary phase external data must be used to upwardly adjust the internal observations. It should be noted that, presumably, the length of internal time series will always be limited due to structural changes within organisations, definition of default, and so forth. Hence, it is very likely that this asymmetric approach will apply in a large number of circumstances.

In the chart below, we plot for example purposes the time series of default rates in Italy (doubtful loans of non-financial companies, source: Bank of Italy). The asymmetric treatment of countries/regions/segments in different phases of the cycle is evident.



The outcome of the requirement is a mixed approach combining the PIT and TTC approaches, which is undesirable from a methodological point of view and has negative implications in terms of pro-cyclical effects (reduction in the volume of credit, tight conditions, revisions of delegated power etc.). In addition, it fails to achieve the declared objective whereby "extensive cyclicality of own funds requirements is avoided" as, after a recessionary phase (as may be the case for most European countries in the forthcoming years), banks would be allowed to repeatedly review their PD calibration downwards until the internally observed average default rate reaches the long-term average.

More generally, we remark that both the regulatory standards and the industry practices still lack a clear definition of PIT/TTC. This also affects the reliability of PD backtesting, because, for example, the standard binomial test on the previous year(s) PD and default rates is only suitable for pure PIT rating systems, while for TTC or hybrid systems the comparison between the two should take into account the level of the cycle in the backtesting period and the degree of cyclicality of the rating system.

We believe that a PD calibration framework should be developed, encompassing a measure for rating system stability and a consistent set of PD backtesting.

Q4: Do you agree with the required number of default weighted average LGD calculation method introduced in Article 51(1)(b) and supportive arguments? How will this requirement influence your current LGD calculation method? More generally, what are your views as to balance of arguments for identifying the most appropriate method?

We agree with the default weighted average LGD calculation method proposed in the document.

In our opinion, this approach is preferable because, on the one hand, it allows for using the exposure at default as a risk driver when it is statistically significant and predictive and, on the other hand, potential bias effects caused by excessively small/large defaults in the exposure weighted approach can be avoided; as a result, management of counterparties' size is more effective.

However, we believe a certain degree of flexibility should be maintained: in particular for low default or small portfolios, where it may be impossible to break down the sample into pools with a statistically significant number of observations, the exposure weighted average LGD calculation method can be a second-best technique to factor exposure size into the model.

Finally, we agree with the exposure weighted method for the floor definition, since the latter represents the whole portfolio and not the single exposure.

Additional comment on Art. 51

The statement, "the capitalised unpaid late fees are added to the institution's measure of exposure and loss" should be elaborated further. It is unclear: a) whether those items should always be added to EaD or only when they are capitalised according to accounting practice; b) whether cash received from them should always be added to recovery cash flows or only when capitalised. In addition, please note that this topic could be influenced by different accounting practices among banks.

Q5: Are the provisions introduced in Article 52 on the treatment of multiple defaults sufficiently clear? Are there aspects which need to be elaborated further?

We believe that the provisions introduced on this issue are sufficiently clear, though we suggest providing guidelines about how long the "short period of time" mentioned in the document should actually be, preferably allowing for differences among risk components and/or steps of the development process.

We also ask that further examples be provided of the management of cure period positions in the PD and LGD estimation.

Articles 53/54 Text for consultation purposes

Articles 53 and 54 deal with the concepts of "economic downturn", which concerns performing exposures, and the "unexpected loss that might occur during the recovery period", which concerns non-performing exposures.

As stated in the Background and Rationale, “LGD for defaulted exposures should reflect the sum of expected loss under current economic circumstances and possible unexpected loss that might occur during the recovery period, whereas the LGD for non-defaulted exposures always reflects the downturn conditions”.

Our understanding is that the two concepts, though obviously connected, differ. We believe that additional guidance is needed to clarify the difference between them.

Q6: Are the provisions introduced in Article 60 on the treatment of eligible guarantors for the purpose of own-LGD estimates sufficiently clear? Are there aspects which need to be elaborated further?

The provisions introduced on this issue are sufficiently clear.

It would be useful to confirm whether retail entities (individuals, SME retail counterparties, etc.) are included among “guarantors that are internally rated with a rating system approved under the IRB approach”, with the consequent possibility of portfolio translation in case of eligible guarantees for the calculation of risk-weighted assets.

Q7: Do you support the view that costs for institutions arising from the implementation of these draft RTS are expected to be negligible or small? If not, could you please indicate the main sources of costs?

We do not share the opinion that the costs of implementing these measures are negligible or small. The proposed methods for PD and LGD estimations will lead to structural changes in financial institutions’ models, namely for those that have IRB models aligned with current (IAS 39) and future accounting practices (IFRS 9). The following aspects will lead to significant costs and could be a step back in the ongoing approval processes with the local supervisory authorities:

Costs arising from the transformation of delinquency data sets according to the rules defined for multiple defaults. There is a possibility that this might not be achieved for periods preceding certain cut-off dates (due to specificities of IT systems or changes in the data recovery processes within the banks), which will lead to loss of statistical information and major pressure over the 5-year minimum threshold for observable data.

Unclear rules regarding PD adjustment to reflect a complete economic cycle, and the introduction of requirements regarding the reconstruction of periods for models in which the observed data is not representative, will lead to structural changes in current PD models under the IRB approach, with major consequences across different business lines that depend on these models (e.g. pricing and loan granting).

A default weighted LGD approach will lead to an overall reconstruction of LGD models and to the evaluation of new segments, with consequences on the provision side of the banks' P&L which should be, to some extent, aligned with IRB models in order to overcome excessive shortfall deductions on CET1. There is also a significant level of uncertainty regarding the potential impact that such changes could have on the current capital requirements and on the P&L side of institutions (due to changes in provisions).

Q8: What are the main benefits for institutions that you expect by the adoption of these draft RTS?

Q9: Do you expect that these draft RTS will trigger material changes to the rating systems (subject of the RTS on materiality of model changes)? If yes, could you please indicate the main sources of the changes (please list the relevant Articles of these draft RTS)?