

**CP ON DRAFT RTS ON ASSSESSMENT METHODOLOGY FOR IRB APPROACH**

**EBA/CP/2014/36**

**12 November 2014**

Dear Sirs

*The BBA is the leading trade association for the UK banking sector with 200 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide. Eighty per cent of global systemically important banks are members of the BBA. As the representative of the world’s largest international banking cluster the BBA is the voice of UK banking.*

*We have the largest and most comprehensive policy resources for banks in the UK and represent our members domestically, in Europe and on the global stage. Our network also includes over 80 of the world’s leading financial and professional services organisations. Our members manage more than £7 trillion in UK banking assets, employ nearly half a million individuals nationally, contribute over £60 billion to the UK economy each year and lend over £150 billion to UK businesses.*

Whilst technically this RTS sets the approach that competent authorities should take to assessing firms’ IRB approach, in practice much of it is setting standards for our members who use the IRB approach to calculate regulatory capital.

The BBA is therefore pleased to respond to the EBA consultation on the specification of the assessment methodology for competent authorities regarding compliance of an institution with the requirements to use the IRB approach. [[1]](#footnote-1)

We would be happy to meet with the EBA to discuss and clarify the comments in this response.

Yours faithfully

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# Introductory Comments

Before responding to the EBA’s specific questions we highlight below some more general comments.

We think that the RTS lends support to the argument that the calculation of capital derived from the IRB approach should remain a cornerstone of the prudential capital framework and institutions that obtain and maintain approval to use the approach should be permitted to do so.

It provides clarity with regard to the Directive and the Regulations; facilitates IRB institutions reviewing and enhancing their model development, validation, independent review and internal audit functions; sets out guidance to improve the use test, and leads to achieving the EBA objectives of ensuring consistency in model outputs and comparability of risk-weighted exposure amounts.

## Background and Rationale

The process to be adopted by the competent authorities in performing a regular review of the IRB Approach at least every 3 years is not described. Whilst our members understand the purpose of the review, the approach taken will determine the costs for the competent authorities as well as our members. We are therefore unable to fully respond to Question 7 until the assessment process is understood.

## Assessment methodology of use test and experience test

Our members believe that the process of using the outcome of the IRB models for internal capital allocation, as proposed in Article 18, should be amended to recognise that it is not mandatory to use the outcome and that an institution may have other approaches.

## Methodology for assessing requirement specific to own-LGD estimates

In relation to Article 51, we think that there are circumstances in which an exposure-weighted LGD is an appropriate estimate, especially for portfolios in which there may be EaD concentration risk. Our response sets out the circumstances on why this may be appropriate and proposals to ensure conservative values offset a few big defaults.

## Treatment of multiple defaults

The purpose of this RTS is to specify the assessment methodology to be used by competent authorities; not to specify how defaults should be treated. Some of our members disagree with the proposals. The issues form part of the application of the definition of default and, as this is being considered under the Guidelines to be issued in accordance with Article 178(7), the proposals should be removed from this RTS.

## Assessment methodology for stress test used in assessment of capital adequacy

We support the need for robust stress testing. However the proposals in Articles 66 to 69 are broad-ranging and it is not clear how they are relevant to Pillar 1 and Pillar 2 respectively nor how they relate to the separate stress tests undertaken by the PRA and the EBA. Further clarification is requested.

# Response to the specific questions

## Q1:

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

**Response**

* BBA members agree with the principle of the regulatory competent authority (RCA) assessing firms for IRB permission based on a consistent and proportional basis.
* We acknowledge that the draft RTS presents a set of requirements and detailed guidance which go some way to achieving consistency in the IRB application process; however we also note that these requirements seek a standard of IRB application which is beyond that required by the CRR.
* The draft RTS in its current format sets out minimum standards, upon which RCA’s have the ability to apply incremental additional requirements or restrictions; however we would consider many of the requirements within these minimum standards as already being above and beyond the application of the CRR rules.
* BBA members consider that meeting the requirements of this draft RTS will not only require material investment from existing IRB firms, but they will inevitably set a higher and more costly target for challenger firms seeking IRB permission to achieve. Our members would question whether this is the intention of article 143.5 of the CRR.
* In relation to the completion of sequential implementation of the IRB approach, our members do not agree that a maximum timeframe of five years should be defined. The timeline for firms to complete sequential IRB implementation should be agreed by the individual competent authorities.
* Any maximum timeframe for firms’ implementation should also take into account any changes impacting the IRB coverage requirements in the EBA RTS CP/2014/10 on sequential implementation and permanent partial use.
* The CP proposed an overall 8% limit on permanent partial use of the Standardised approach for the exposures specified in Article 150(1) (c) of the CRR. If more portfolios are required to be covered by IRB, these are likely to be smaller, more difficult to model portfolios, with potentially less data and hence the maximum time required to achieve IRB implementation may extend beyond the suggested five year period. These are also the reasons for seeking a higher limit for permanent partial use.
* The CP states that competent authorities may approve any changes to the sequence and time period of the IRB roll out plan only where certain conditions are met. In reality, our members do not seek approval from the competent authority for most changes to the ROP but rather keep them informed.
* The requirements proposed set out a lot of work that competent authorities should do in assessing firms’ models. It does not set out any timescales in which this work should be done. Our members believe it would be useful to introduce competent authority SLAs on model related reviews. This would be in line with EBA criteria on the time regulators should spend reviewing joint decision models (where a decision must be made in six months). The same requirement should be applied also to models that are not subject to a joint decision.

## 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?

**Response**

* Our members generally agree with the proposals but request further clarification as the draft RTS appears to conflict with CRR text.
* We support the principle that IRB rating systems should be subject to appropriate and proportionate review and validation. The CRR introduces several control levels with their particular roles and responsibilities:
  + The business functions which originate and renew exposures
  + The Credit Risk Control Unit
  + Validation function
  + Internal Audit
  + Senior management and management body
* The RTS seeks to apply the concept of an “Independent Validation Function” (which is a requirement applicable to the Internal Models Approach for Equities - CRR article 188) to other types of IRB models.
* The CRR articles 174, 185 and 190 require firms to have a Credit Risk Control (CRCU) function and Internal Audit function involved in the management and control of a firm’s rating systems and do not mention "Independent Validation".
* We request clarity on this requirement as to how the activities of the independent validation function should interact with, and differ from, the CRCU. In particular the delineation of responsibilities for model development, model changes and the validation and on-going maintenance activities.
* We believe that our members are already compliant with the requirements of the CRR Articles referenced above; as such the new requirements of the RTS may require in some cases costly redesign of internal organisational structures and governance frameworks. We would question whether this was the intention of the RTS, given that existing IRB firms have adopted structures which are deemed by them and their RCA as compliant.
* Members consider that RCA’s should retain the ability to approve organisational structures which provide for an adequate control environment with regards to the development, maintenance and validation of rating systems and which meet the CRR requirements.

## Q3:

* Are the provisions introduced in Article 49(3) - Method of PD estimation - on the calculation of the long-run average of one-year default rates sufficiently clear? Are there aspects which need to be elaborated further?

**Response**

* We are concerned that the requirements of Article 49(3) may require a revision to rating systems.
* Our members are concerned that there is a risk that competent authorities may interpret the requirements of CRR Article 180 and this RTS differently, which could result in firms having to adopt a Through the Cycle (TTC) approach for Retail assets, rather than the current Point in Time (PIT) approach approved by the UK competent authority.
* Our members request clarity that the current PiT approach approved by the competent authority, continues to meet the requirements of both CRR Article 180 and the RTS proposals.
* We are in this position because the UK competent authority did not believe that data for unsecured portfolios from the early 1990s downturn was representative due to fundamental changes in the nature of the products and risk appetite.
* Additionally, non-mainstream mortgage products became more prevalent after the early 1990s recession. For these products there is no reliable data. Under these constraints the competent authority preferred banks adopt a PIT calibration and recognise the increased capital cyclicality through the Pillar II process. This capital cyclicality is not desirable but is embedded across the industry. Our members can move away from this position only where more recent recessionary experience is accepted as a downturn and a TTC calibration is approved based on this data.

## 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?

**Response**

* We think that there needs to be a better comprehension of the purpose of the two components of the Expected Loss and Unexpected Loss, namely EaD and the loss % (PD and LGD) for non-defaulted exposures:
  + EaD defines the quantum of exposure
  + PD and LGD defines the riskiness
* We agree that for high-default portfolios in which there is an absence of any EaD concentration risk (granularity risk), a default-weighted LGD calculation is appropriate and is consistent with the approach to PD.
* However, for low default portfolios and or those portfolios containing concentration EaD risk then it is prudent to take into account in some way the riskiness of each exposure.
* We recognise that an institution is required to take to take into account concentration (granularity) risk in its ICAAP and competent authorities are required to assess this risk in the Pillar 2 assessment.
* In practice, IRB institutions segregate their Corporate portfolios by size, such as Large Corporates, Medium Corporates and SMEs, and Retail portfolios between mass-market and private banking. Thus the modelling of PD and LGD for these differentiated portfolios takes into account the actual losses and actual LGD.
* However, for some institutions where it may be impractical to segregate portfolios, and or where it may have a concentration risk, then it would seem prudent to take into account this risk in Pillar 1 through an LGD estimate that reflects this risk, if an institution chooses to do so.
* Therefore to the extent that an institution includes this risk in its estimate of ELGD, we consider that an exposure weighted LGD estimate should be permitted and in turn should have an impact upon a Pillar 2 assessment.
* We consider that it would be preferable to include a guiding principal that an exposure-weighted LGD cannot be less than a default-weighted LGD in order to
  1. ensure a degree of conservatism and
  2. to eliminate the possibility of a few big defaults leading to a less robust estimation.
* Additionally members are concerned that the text within paragraph 5 could be misinterpreted as requiring PD’s to be reflective of a Stressed position, rather than the long-run, therefore introducing the concept of accounting for stress in Pillar 1.
* We believe this would be a change to the fundamental methodology of the three pillars approach and as agreed during the EBA Hearing held in London (9th February 2015) this is not the intention of the RTS and firms would not be expected to align Pillar 1 IRB parameters to the equivalent of Pillar 2 stressed outcomes.
* We propose the following amendment to this paragraph:
  + *For the purposes of paragraph 1, for exposures to corporates, institutions, and central governments and central banks, where the obligors are highly leveraged or with predominantly traded assets, competent authorities shall verify that the PD accounts for the performance of the underlying assets* ***in a complete economic cycle*.**

## 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?

**Response**

* Additional clarity would be welcome around the assignment of the status of’ ‘no longer in default’ (cured). However, the purpose of this RTS is to specify the assessment methodology to be used by competent authorities; not to specify how defaults should be treated.
* Any changes to requirements should be presented as part of a comprehensive review of the application of the definition of default. We are concerned that at present the various requirements linked to the default definition are spread over several references
  + The default materiality threshold as defined in the RTS on credit obligations past due
  + Non performing/forborne exposures
  + Multiple defaults (Articles 49 and 52 of this draft RTS)
  + Forthcoming EBA Guidelines on Default (CRR Article 178)
  + BCBS work on modelling constraints for credit risk parameter estimates
* Therefore, it is hard to have a comprehensive overview of the definition of default. Default is a key component of the IRB approach. Any change or evolution in this definition requires thorough consideration as it implies a heavy workload for firms, an impact on RWAs and material changes that need competent authority approval.
* Per the EBA Discussion Paper on the future of the IRB approach (EBA/DP/2015/01, 4.3.1(iii), para 35), return to non-defaulted status will be clarified in the Guidelines (GL) to be issued in accordance with Article 178(7). The proposals regarding the treatment of multiple defaults should therefore be removed from this RTS.

## 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?

**Response**

* We agree that as there seems to be a contradiction between Articles 183(4) and 201(2) of the CRR.
* The EBA clarification as set out in Article 60 is logical and states that unfunded guarantees will be reflected in PD. However, it is not clear how this interacts with Article 164 which states unfunded guarantees can be used in PD or LGD.
* In practice, this contradiction is a moot-point for institutions that have implemented an IRB approach for exposures to those obligors that provide guarantees including CDS.

## 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?

**Response**

* If the changes require a revision to rating systems or organisational/governance structures then the costs arising from the implementation of these draft RTS are not likely to be negligible or small. For example, the costs of changing the definition of default would lead to additional data capture exercises, and remodelling activity across multiple rating systems.
* The constraints introduced to implementing Roll out plans could force bringing forward modelling activity when data (for example) may not be available leading to costly workarounds and competent authority review of models which may not necessarily compliant, but which must be submitted to meet a meaningless deadline.
* Additionally, the process to be adopted by the competent authorities in performing a regular review of the IRB Approach at least every 3 years is not fully described. Whilst our members understand the purpose of the review, the approach taken will determine the costs for the competent authorities as well as our members. We are therefore unable to fully respond until the assessment process is understood.

## Q8:

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

**Response**

* We think that it provides clarity with regard the Directive and the Regulations; facilitates IRB institutions:
  + reviewing and enhancing their model development, validation, independent review and internal audit functions;
  + sets out guidance to improve the use test, and
  + in some instances (we believe we have highlighted where we do not believe this benefit would materialise) leads to achieving the EBA objectives of ensuring consistency in model outputs and comparability of risk-weighted exposure amounts

## 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)?

**Response**

* We are concerned that the requirements of Article 49(3) may require a revision to rating systems.
* There is a risk competent authorities may interpret the requirements of CRR Article 180 and this RTS differently, which could result in firms having to adopt a ‘Through the Cycle’ approach for Retail assets, rather than the current PIT approach approved by the UK competent authority.
* Our members would request clarity that the current PIT approach continues to meet the requirements.
* Additionally our members are concerned that changes to the Definition of Default could require material changes to be made to existing rating systems.
* Members request that changes to the Definition of Default be proposed and assessed in a cohesive and compressive industry consultation, outside of this RTS.

# Comments upon specific articles not covered by questions

## Internal Capital Allocation - CHAPTER 4 – Article 18

**Pre-amble (11)**

* *In order to ensure a minimum level of harmonisation in relation to the scope of use of the rating systems (the so-called ‘use test’), competent authorities should verify that the rating systems are incorporated in the relevant processes of the institution within the broader processes of risk management, credit approval and decision-making processes,* ***internal capital allocation****, and corporate governance functions.*

We note that in Article 18.1

1. *internal ratings and default and loss estimates of the rating systems used in the calculation of own funds play an essential role in all of the following areas:*

*(ii) in the process of the internal capital allocation in accordance with Article 20;*

*Article 20 Use test in the internal capital allocation*

*1. In assessing whether internal ratings and default and loss estimates of the rating systems used in the calculation of own funds requirements play an essential role in the institution’s internal capital allocation as referred to in Article 18(1)(a)(ii), competent authorities shall evaluate whether these ratings and estimates play an important role, in particular, in:*

1. *assessing the amount of internal capital of the institution in accordance with Article 73 of Directive 2013/36/EU;*
2. *distributing the internal capital among types of risk, subsidiaries and portfolios.*

Article 73 of the Directive sets out the guidance with respect to ICAAP

*Institutions shall have in place sound, effective and comprehensive strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that they consider adequate to cover the nature and level of the risks to which they are or might be exposed.EN 27.6.2013 Official Journal of the European Union L 176/377*

*Those strategies and processes shall be subject to regular internal review to ensure that they remain comprehensive and proportionate to the nature, scale and complexity of the activities of the institution concerned.*

**Our comments**

Our members do not agree with the interpretation of the CRR Article 144.1b within the RTS Article 18.1a. The use of IRB estimates has always been split into the “Core” and “Broader” areas, reflecting those uses which are essential and those where IRB outputs should play an important role. Our members believe that IRB estimates should play an important role in the allocation of internal capital, but that other factors may, and are considered.

We think that the RTS should be revised to recognise that the IRB estimates may be used by institution to assist in internal capital allocation as set out in Article 20, but it is by no means the dominating factor as the RTS implies.

## Article 3 - General rules for the assessment methodology

We note and agree with the general intention and principle behind this article; however it is our view that the level of detail and prescriptiveness is excessive. We would recommend removing sub-point e) and allow RCA’s to assess the finer details of documentation standards on a proportionality basis.

## Article 4 – Outsourcing

Our members note that the principle of Outsourcing should be clarified to confirm that legal entities within the firm’s own company structure are not considered to be “a third party vendor”. An example would be where a parent company provides rating system capabilities to a subsidiary within the same banking group.

## Article 17 – Internal Audit

As referenced in the below comment relating to Article 32.9b; our members consider that the Internal Audit review of the regulatory self-assessment process would be most appropriate to feature within Internal Audits annual review of the rating system, as required by CRR article 191.

## Article 32 – Completeness of Documentation

Paragraph 9a) – Members’ request a minor amendment to this paragraph: “(a) the documentation includes a description of the institution’s self-assessment of compliance with the relevant regulatory requirements for the Internal Ratings Based Approach as referred to in Section 6, Chapter 3, Title II, Part three of Regulation (EU) 575/2013;”

Our members disagree with point 9.b) the requirement for the compliance self-assessment of rating systems to be reviewed by internal audit or an equivalent auditing unit prior to its inclusion in rating system documentation.

This is not a “3rd line” activity and therefore it would not be appropriate for Internal Audit to review the self-assessment for every rating system change document and submitted for approval to an RCA. Our members request that this is removed from Article 32 and recommend that a review of the operation of the self-assessment process should be included within Article 17.1a:

## Article 24 – Assignment definitions, processes and criteria

Paragraph 1.g

* Whilst our members acknowledge the principle of accounting for missing or not up-to-date information, they disagree with the inclusion of an arbitrary value of 24 months being included within regulation, determining the age that financial statements are considered not up-to-date. Members are cognisant of the fact that missing or stale information should be treated under the “accounting for uncertainty” principle. Our members therefore request the removal of the 24 month consideration.

Paragraph 2.e

* Members request rewording of this requirement to reflect the expectation that RCA’s assess the presence and effectiveness of an institution's internal control framework, as opposed to assessing whether 'the number and justifications for overrides do not indicate significant weaknesses of the rating model'.

## Article 51 and 57

Members request the addition of the word “relevant” to the text “all relevant observed defaults”; to reflect the fact that not all defaults are representative and therefore may be present in the data sources but would be excluded from some or all aspects of rating system development.

## Article 55 - Requirements on collateral management, legal certainty and risk management

Our members support the expectation that firms' policies and procedures on Legal Certainty should be fully consistent with FIRB requirements, given the binary function of this characteristic.

However they do not support the expectation that policies and procedures on collateral valuations should be fully consistent with FIRB requirements. It has been demonstrated that uncertainty associated with a collateral valuations can be appropriately estimated and accounted for within a model framework. It is therefore not always appropriate or warranted to apply the FIRB standards to AIRB portfolios.

## Articles 66 to 69 - Assessment methodology for stress test used in assessment of capital adequacy

We support the need for robust stress testing.

However the proposals in Articles 66 to 69 are broad ranging and it is not clear how they are relevant to Pillar 1 and Pillar 2 respectively, nor how they relate to the separate stress tests undertaken by the PRA and the EBA. Further clarification is requested.

## Correctness of the implementation of the methodology and procedures for different exposures classes - CHAPTER 11 – Article 73

*(b) the calculation of the correlation coefficient (‘R’) is done in accordance with the characteristics of certain exposures, in particular that the total sales (‘S’) parameter is applied on the basis of consolidated financial information;*

**Comments**

For the sake of clarification the total sales (‘S’) parameter should be applied at the level at which the PD is assigned.

It is possible that an institution may have rating system in which it considers each member of a group of companies to be standalone and capable of defaulting and thus not being subjected to any parental support.

In such a case it would be appropriate to use the sales parameter of the rated obligor.

**Effective maturity (M)**

*In particular it has been clarified that where effective maturity is calculated for the revolving exposures it should be based on the expiry date of the facility. Assignment of the M parameter based on the repayment date of a current drawing is not sufficient because it does not account for possible additional drawings. In fact the institution is at risk for a longer period than the repayment date of the current drawing*.

We note that Article 73 states

*(d) the calculation of the maturity (M) parameter is correct, and in particular:*

*(i) that for the purpose of Article 162(2)(f) of Regulation (EU) No 575/2013 the maturity parameter is calculated using the expiry date of the facility;*

**Comments**

We disagree with the proposed RTS.

Article 162.2 of the Regulation states:

*(a) for an instrument subject to a cash flow schedule, M shall be calculated according to the following formula where CF t denotes the cash flows (principal, interest payments and fees) contractually payable by the obligor in period t;*

*(f) for any other instrument than those mentioned in this paragraph or when an institution is not in a position to calculate M as set out in (a), M shall be the maximum remaining time (in years) that the obligor is permitted to take to fully discharge its contractual obligations, where M shall be at least 1 year;*

We believe that the RTS should be consistent with the Regulation 162.2f and recognise the approved methodologies for determining effective maturity.

**END**

1. <https://www.eba.europa.eu/documents/10180/891573/EBA-CP-2014-36+%28CP+on+RTS+on+Assessment+Methodology+for+IRB+Approach%29.pdf> [↑](#footnote-ref-1)