The voice of banking
& financial services

A response to the EBA's Consultation on Draft regulatory technical standards on the sequential implementation of the IRB Approach and permanent partial use under the Standardised Approach under Articles 148(6), 150(3) and 152(5) of Regulation (EU) No 575/2013 (Capital Requirements Regulation– CRR) by the British Bankers' Association

September 2014

Dear Sirs

The BBA is the leading association for banks active in the UK. It represents over 170 banking members, 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 as well as a range of other banks from Asia, including China, the Middle East, Africa and South America. 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. As well as banks headquartered in the UK our members include third country banks which operate in the UK many of them through subsidiaries authorised by the PRA as UK banks in their own right. So this consultation paper is relevant to the activities of many of our members.

The BBA is pleased to respond to this consultation on the draft RTS[1].

Summary comments

In our opinion this RTS is one of the most important that the EBA is required to develop.

- Within a risk sensitive framework, institutions should be encouraged to develop IRB models and procedures where the data and information exists to support this.

- The CRR (Article 148) recognises however that it is not always practical, or feasible, for institutions to develop IRB models across their entire portfolios, as there are instances where data is insufficient to build or to maintain a model, either temporarily or permanently. Flexibility is required, and provided in the current regulatory framework in the form roll-out plans discussed and agreed by each IRB institution with its home and host regulators.

- Roll-out plans should be refreshed annually. They should address strategic changes to business mix, including through mergers, acquisitions and disposals as well as strategic decisions to exit markets and/or portfolios. Institutions may have IRB portfolios in run-off where modelling is no longer appropriate and for which exemptions under CRR 149 should allow reverting to the Standardised Approach without impacting IRB minimum ratios. We note that any perceived or actual underestimation of the own funds requirement can be compensated for in Pillar 2.

[1] https://www.eba.europa.eu/documents/10180/740958/EBA-CP-2014-10+CP+on+draft+RTS+on+roll+out+and+PPU+of+IRB+approach.pdf

- We understand the EU's desire for introducing greater consistency regarding the conditions for permanent partial use of the standardised approach. We agree with the EBA that strict criteria are needed to guard against divergent interpretation across jurisdictions and inconsistent treatment between institutions.

- To aid consistent implementation, we would suggest that a global single target coverage ratio should be introduced to cover credit exposures at a consolidated level. This recognises that there will always be subsets of portfolios for which IRB model development is not feasible and that some modification to the treatment for certain asset classes may be needed.

- The target ratio should be set by reference to a single risk sensitive measure such as RWA normalised for sovereign exposures that are risk-weighted with 0% under the SA. The threshold should not be set on the basis of EAD as EAD is not risk sensitive and using both RWA and EAD would make the process unnecessarily complex. The methodology adopted for calculating the target ratio should be aligned with that employed for calculating the minimum 50% threshold for IRB coverage.

- The [8%] thresholds proposed in article 2(1)(a) and (b) of the draft RTS should be removed as the CRR mandate is to determine conditions for i) the identification of the maximum number of material counterparties to be considered limited and ii) the assessment of whether the implementation of a rating system would be unduly burdensome. To determine an overall threshold for condition i) is not in line with the CRR mandate. Instead, the RTS should be developed on the limited number of material counterparties and the avoidance of the implementation of unduly burdensome rating systems for such counterparties. A threshold of [8%] per asset class does not provide competent authorities with sufficient flexibility to take into account the specific business/asset mix of institutions.

Conclusion

In conclusion we recommend simple principles based framework supplemented by the above core principles. This will benefit both competent authorities and institutions, levelling the playing field and enabling sensible dialogue to address firm specific idiosyncratic differences and guard against regulatory concerns relating to "cherry picking".

We enclose a response to the 6 questions.

The BBA and its members are at your disposal to meet to clarify any of the comments set in this letter and the supporting comments relating to this important RTS.

Yours faithfully

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Q1: Do you agree with the proposed draft RTS regarding the sequential application of the IRB Approach?

Whilst we broadly agree with the 50% initial threshold, we do not agree with a number of proposals contained within the Draft RTS. We caution that in order for the sequential application to be effective due consideration needs to be taken into account in a firm's individual roll out plan of, inter alia:

1. The structure of institutions as well as include non-EU subsidiaries and exposures,
2. both the local and consolidated reporting status of a portfolio,
3. the application of the overall measure of materiality at a consolidated level only,
4. where possible the alignment of simple, well understood, definitions with the minimum IRB threshold defined in Article 4,
5. the ability for institutions to diverge from the immateriality and minimum coverage ratios on a purely solo basis, provided agreement is obtained from the relevant group of regulators, and
6. the overall pace and direction of a firm's Roll out plan, taking account of asset and portfolio mix.

We draw the EBA attention to the following:

7. The RTS proposes coverage of only the denominator (Risk Weighted Assets). The approach ignores the numerator in the capital ratio, namely the own funds (Capital) that include credit risk adjustments and deduction of expected losses. The regulation Article 148 (3) requires an assessment of the capital ratio i.e. both the numerator and demonstrator, not just the risk weighted assets and or EAD as set out in the draft RTS.
8. If there is to be threshold (refer our answer to Q4) then should be set by reference to a single risk sensitive measure, e.g. RWA and should include all exposures, including defaulted exposures, corrected for EL where appropriate. [3]
9. The requirements set out in Regulation 500 regarding transitional provisions that has an overarching floor of 80% for institutions commencing using IRB after 1 January 2010 which is designed to mitigate the potential for underestimating the capital ratio.
10. It includes measures based upon EAD that is not risk-sensitive. For the exposures to central governments & central banks, institutions and corporates the implied requirement in the regulation (Article 150 (1) is to assess the risk weights.
11. It inappropriately excludes from the minimum coverage ratio the exposures to central governments, central banks and institutions when prior permission has been into granted to apply the Standardised Approach as per Article 150 (1) (a) and (b). This is because the total on which the 50% thresholds are applied excludes those exposures. This is inappropriate because it might encourage an institution not to use the IRB approach for those exposures.

[3] In order to achieve an improved level of comparability between the Standardised Approach and IRB Approach, a suggestion would be to compare only non-defaulted exposures and with respect to IRB to add back to the IRB RWA a notional IRB EL RWA equal to EL [3] x 12.5.

12. It does not take into account non-significant business units and immaterial exposure classes that in aggregate can be significant, but cannot be measured on an IRB basis because they do not meet the IRB requirements.

Our recommendations:

We believe that the EBA should take a principles-based approach to a firm's Roll-out plans that allows institutions and competent authorities to take into account the Articles 6, 7 and 11 of the Regulation.

The overriding requirement should be compliance with the requirements of the IRB approach as set out in Title II Chapter 3 Section 6 Articles 169 to 191 to determine which exposures should be measured on an IRB basis. The percentage coverage ratio and the timetable for achieving this should be set on a consistent basis across the EU left to the agreement between the home and host country competent authorities.

In order to be able to compare "like with like", the proposed risk metric should be the aggregate of:

I. For IRB portfolios: RWA plus RWA equivalent of EL-provisions, and
II. For Standardised portfolios: STD RWA, and
III. All Defaulted exposures.

Additional points to which we draw the EBA attention:

A. Scope covered by the RTS

It is important that a consistent, common scope is applied across member states. In the UK, this is based upon Part Three, Title II, Credit Risk, Chapters 1 through 6 (that also includes Credit Risk Mitigation, Securitisation and Counterparty Credit Risk). In addition, the existing target ratios are set at the consolidated level, and so, by definition, disregard intragroup exposures where it is challenging to develop IRB measures.

B. Common definitions

Paragraph 1 of Article 1 of the draft RTS uses the term "exposure value". is referred to. We understand that the intention is to use the exposure value as defined in articles 111 and 166 to 168 of CRR for the standardised approach and the IRB approach, respectively. It would be helpful to confirm if such "exposure values" are to continue as the basis of calculation in future versions of the RTS.

Q2: Do you agree with the proposed draft RTS regarding permanent partial use of the Standardised Approach (SA) for the exposures specified in Article 150 (1) (a) and (b) of the CRR?

In summary we do not support the proposals as set out.

We concur with the views of the EBF on this aspect which we repeat below for completeness.

We believe that point (a) and (b) of Article 2 (1) of the draft RTS, which sets an immateriality limit in the RTS in relation to the institution's' total exposure value of the set of relevant exposures and the total risk-weighted exposure amount of the set of relevant exposures, go beyond the scope of the provision laid down in point (a) and (b) of Article 150 of the CRR.

The relevant criteria in point (a) and (b) of Article 150 of the CRR are the number of material counterparties and the burden for institutions to implement rating systems for these counterparties. Accordingly, we believe that point (a) and (b) of Article 2 (1) should be deleted from the RTS.

The text in article 150(1)(a) and (b) of CRR refers to exposures where:

(i) the number of material counterparties is limited; and
(ii) it would be unduly burdensome for the institution to implement a rating system for these counterparties.

The former is addressed in article 2(1) point (c) of the RTS. The latter is dealt with in the qualitative criteria section.

An 8% threshold could impose undue pressure on both competent authorities and banks to implement models that may not fully comply with the applicable minimum standards.
In conclusion, we believe that the introduction of a quantitative threshold in the RTS (as the proposed 8%) distorts the spirit of the regulation; and brings in unnecessary complications.

As for the definition of "unduly burdensome" the EBF suggests removing article 2(2) and instead indicate that reliance is placed upon an institution to prove that it cannot comply with Title II, Chapter 3 (Credit Risk), Section 6 (IRB approach) Articles 169 – 191.

Our recommendations

No restrictions for EAD and RWA should apply under CRR 150 paragraph 1. (a) and (b) since such restrictions would otherwise be foreseen in the CRR text, which they are not.

The residual threshold of 20 obligors in each exposure class is sufficient and is in line the generally accepted threshold for modelling LGD.

Q3: Do you agree with the proposed draft RTS regarding permanent partial use of the SA for the exposures specified in Article 150 (1) (c) of the CRR?

In summary we do not support the proposals as set out.

To minimise potential for confusion and to aid consistent implementation, a global single target coverage ratio should be introduced covering all credit exposures at a consolidated level. This recognises there will always be subsets of portfolios for which IRB model development is not feasible and that some modification to the treatment for certain asset classes may be needed.

The threshold should be set by reference to a single risk sensitive measure, e.g. RWA and should include all exposure, including defaulted exposures, corrected for EL where appropriate.

The treatment of sovereign exposures should be normalised to remove current anomalies relating to zero risk weighted sovereigns and for the purposes of assessment against any target ratio. This will ensure greater consistency and comparability between institutions as well as ensuring the correct incentive to develop risk based models where it is appropriate to do so.

We draw the EBA attention to the following points that it should consider:

If for a portfolio - in the event that it is not possible to estimate own values for PD, LGD, and EAD (and thus cannot be IRB compliant) – thus requiring a continuation on the Standardised Approach, then an assessment should be made to determine if the capital requirement is understated. If it is then competent authorities have many tools to compensate for perceived and or actual shortcomings, including the Pillar 2 process (Pillar 2A and or Pillar 2B as per the UK PRA).

The draft RTS as proposed produces a cliff-effect that results in an entire institution (and at lower levels at whatever level it is supervised) being labelled an IRB compliant or IRB non-compliant institution. Considering the effort expended by many EU institutions during the past 14 years, it is undesirable that such an outcome might result as consequence of implementation of the EBA RTS.

The EBA also seems to believe that a fixed percentage of 8% or any other % of the minimum of the total of Standardised and IRB EAD and RWA is a measure of immateriality in size and perceived risk not in absolute terms of that risk but in comparison to other risks, and the overall size of the institution. This may not be the case. We believe that the only risk that is relevant is the risk in the portfolio that being assessed for consideration of compliance with IRB. [4]

Our recommendations

As set out in our response to Q1, we believe that the EBA should take a principles-based approach that allows institutions and competent authorities to take into account the Articles 6, 7 and 11 of the Regulation. We recommend that the prescriptive cliff-effect thresholds are dropped.

[4] This also includes any correlation with another portfolio. However, that is impossible to include in a regulatory approach to risk measurement and thus must be considered in Pillar 2.

Instead, we consider that it should be a matter between an institution and its home and host competent authority to agree on which business unit's legal entities are significant and thus should be the primary focus of an IRB rollout plan that then facilitates discussion between competent authorities and agreement in accordance with Article 20 on an institution's application for IRB.

The overriding requirement should be compliance with the requirements of the IRB approach as set out in Title II Chapter 3 Section 6 Articles 169 to 191 to determine which exposures should be measured on an IRB basis. A minimum coverage ratio may be used as a benchmark but should never be a hardwired without due consideration of structure and geography of business activities of the institution.

Q3: Which of the two alternative proposals presented in the impact assessment section under 'Technical options considered' do you prefer?

In summary we do not agree with either of the technical options.

Both approaches imply that an institution will need to estimate its IRB exposures even though it might know them. In many cases this will neither be practical or achievable.

Institutions need simple and straight-forward measures that are not operationally burdensome.

We concur with the view of the EBF as below.

The fixed upper limit of 8% of total exposure value and total risk weighted exposure amount associated with exposures to insignificant business units and/or products seems restrictive and unnecessarily rigid, *cf* point (a) and (b) of Article 3 of the draft RTS. Both technical options seem complicated to implement in practice and both leave significant room for interpretation by competent authorities.

Comparisons between results of the Standardised approach and the IRB approach, such as the one put forward in proposal number 1, should be avoided.

Proposal number 1 presumes that the likelihood of underestimation of risk is necessarily a function of the difference between an approach that seeks to measure risk with a high degree of precision (i.e. IRB) and a method that is much blunter (i.e. SA). This is fundamentally flawed. As a matter of principle, the SA is not a sound reference methodology to ascertain whether a risk is correctly estimated.

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Q4: Do you agree with the quantitative thresholds proposed in Articles 2(1), 3 and 4(2) of these draft RTS?

We agree that the [50%] threshold for an initial coverage ratio make sense.

However, the matter of the final coverage ratio is a separate issue.

The target coverage ratio must thereafter be set at a level that is sufficiently strict to avoid cherry picking, but also be sufficiently realistic that a firm's roll-out plans do not extend over impractically long periods of time. We strongly recommend that such coverage ratio targets are set at a consolidated basis only.

We would recommend the targets should be based on a survey of EU institutions.

This should be based on a simple formula, excluding equity exposures, but with all other credit exposures included.

If not, what thresholds do you consider more suitable?

As expressed in the summary, we do not favour establishing threshold targets as that can have unintended consequences in terms of business mix and approach. We recommend a firm specific target coverage ratio is agreed by each IRB institution with its home and host regulators as part of its annual roll-out plan.

As stated, we do not believe that thresholds should apply at each legal, geographical and or business unit level as there will be many practical limitations

If the EBA still considers that there should be a threshold, then we would suggest that this is set a suitably realistic level to take account institutions' experience in developing IRB models across geography and asset classes.

We believe that for some institutions taking into account their structure that on a consolidated basis this may need to allow up to 25% to be exempt.

We also wish to draw the EBA attention to the following:

Some UK Institutions currently undertake proportional consolidation of their associates as per PRA's application of Article 18 of the CRR. In this instance, where consolidation is required but where no controlling interest exists, a bank is not able to impose the choice of a particular approach upon the associate and even if IRB approach was used, limitations in terms of access to the underlying data and models, as well as the fact that the local IRB models would not have been approved for use by the group consolidated regulator, would force the bank to calculate RWAs for those exposures applying a standardised approach.

This is a situation not currently contemplated in Article 150, but that would need to be taken into account by the EBA when defining conditions of application of some of the points in that article and any materiality threshold calculations. A solution to this situation would be to grant discretion to the competent authority over the inclusion of associates where proportional consolidation is required under the national application of Article 18, in the calculation of thresholds.

Q5: Do you think that separate quantitative thresholds should apply for application of these draft RTS on an individual and on a consolidated basis?

We do not support the EBA proposals. Our response is as follows:

1) Given the wide range of evolving structures, we do not consider that ranges of thresholds can be established to cover all eventualities.

2) We do not agree that effective thresholds need to be imposed on an individual basis.

3) We think that a threshold should only be applied on a consolidated basis. This would allow the percentage in subsidiaries and or businesses units to have varying percentages according to data, model and other limitations.

4) Competent Authorities need to be given the flexibility to react to changes in the legal entity structure, mergers and acquisitions and divestiture and or run-down of portfolios that affect the mix between IRB and Standardised.

5) It is important that such changes do not require an institution to switch its calculation between IRB and Standardised Approaches in a prescriptive manner merely to comply with the RTS.

Which of the two alternative proposals presented in the impact assessment section under 'Technical options considered' do you prefer?

We do not agree with either option

1) Both options are variations on a common theme of the same theme that do not achieve the objective of ensuring flexibility during implementation and thus thereafter that is explicit in Article 148 (3). [5]

2) The explanatory notes states that the "*advantage of the option proposed in the RTS (i.e. application of identical quantitative thresholds on a consolidated and individual basis) is that it results in a level playing field for individual institutions in a given jurisdiction*". We do not agree with the EBA conclusions. The assumption only holds true if the threshold is applied at each level in the legal entity structure. The EBA recognises the shortcomings of its own proposals as causing a conflict between competent authorities to reach an agreement in accordance with Article 20.

3) We believe that the solution is as set out in the answer to question 4 above.

[5] *The competent authority shall design those conditions such that they ensure that the **flexibility** under paragraph 1 is not used selectively for the purposes of achieving reduced own funds requirements in respect of those exposure classes or business units that are yet to be included in the IRB Approach or in the use of own estimates of LGDs and conversion factors.*

Q6. Do you agree with our analysis of the impact of the proposals in this Consultation Paper?

The impact will depend upon the flexibility of the RTS in terms of timeliness/structure of roll-out plan recognising that each bank has its own business/asset mix, including mergers/acquisitions/exit decisions and updating the roll-out plan is important to keep flexibility at a solo level.

If not, can you provide any evidence or data that would explain why you disagree or which might assist our analysis of the possible impact of the proposals?

The answers to questions 1 – 6 set out above set out our comments.

In addition we draw the EBA attention to one other consultation relating to Article 144 [6] that the EBA has not yet published that may have impact upon the draft RTS. Without sighting that finalised RTS it is not possible to fully assess the implications upon the proposed RTS.

[6] Article 144 sets out the approach for "*Competent authorities' assessment of an application to use an IRB Approach*". It is noted that in Article 144 the EBA is required to draft an RTS to specify the assessment and submit the draft to the Commission by 31 December 2014.